# LOCAL-LEVEL POLICIES FOR SMALL FIRM SECTOR DEVELOPMENT IN RUSSIA AND HUNGARY: A COMPARATIVE ANALYSIS

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This work or any part thereof has not previously been presented in any form to the University or to any other body whether for the purpose of assessment, publication or for any other purpose (unless previously indicated). Save for any express acknowledgements, references and/ or bibliographies cited in the work, I confirm that the intellectual content of the work is the result of my own efforts and of no other person.



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Date..... 17/4/2000 .....

## Abstract

The fall of the Berlin Wall in 1989 heralded the beginning of systemic transformation from centrally-planned to market-type economies in Eastern Europe. From the outset, reforms were shaped by a neo-liberal policy agenda which was grounded in the belief that private ownership and markets would bring about resource reallocation and instigate growth. However, the experience after a decade of transition suggests that this agenda has been inadequate in addressing the complex social, economic, political and structural problems of the region. The progress that has been made in attaining macroeconomic stability continues to be threatened by the lack of deep restructuring at the microlevel. In this context, the development of new small firms assumes critical importance as they are viewed as key agents in the process of structural change in the transition economies. However, the development of small firms continues to be stymied by a number of internal and external factors.

This thesis seeks to contribute to the growing literature on small firm development in Eastern Europe by taking a closer look at policy issues. Given the lack of domestic experience in the promotion of small firms, policy-makers in the region are looking to adopt 'best practice' from elsewhere. The question that emerges is whether these imported policies are appropriate in the context of transition economies. The research seeks to fill some of the gaps in the literature by exploring the theoretical and policy implications of the relevance of Western small firm policy experience in the context of two very diverse transition economies - Hungary and the Russian Federation. The research focuses especially on small firm policies developed at the local level in Russia and Hungary and aims to establish the extent to which emerging policies have been taken 'off the shelf'. On the basis of regional case studies, the appropriateness of such policies will be explored.

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## Abbreviations

| | |
|---|---|
| BEA | Budapest Enterprise Agency |
| BoP | Balance of Payments |
| CMEA | Council for Mutual Economic Assistance |
| EBRD | European Bank for Reconstruction and Development |
| EU | European Union |
| FDI | Foreign Direct Investment |
| GDP | Gross Domestic Product |
| HUF | Hungarian Forint |
| KSH | Központi Statisztikai Hivatal (Central Statistical Office) |
| LEA | Local Enterprise Agency |
| NBH | National Bank of Hungary |
| MCC | Mondragon Corporacion Cooperativa |
| MVA | Hungarian Foundation for Enterprise Promotion |
| OECD | Organisation for Economic Co-operation and Development |
| PHARE | Poland, Hungary, Assistance to the Restructuring of the Economy |
| Rb | Rouble |
| SSB | Szabolcs-Szatmár-Bereg |
| SME | Small and medium enterprise |
| SOE | State-owned enterprise |
| TACIS | Technical Assistance to the Commonwealth of Independent States |
| USAID | United States Agency for International Development |

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## Introduction

Since 1989, momentous changes have occurred in the countries of Central and Eastern Europe as communism and the command economies were dismantled and transformation towards democratic market-type economies started to get underway. Initially, there was a widespread acceptance of neo-liberal doctrine among policy-makers in the region and their Western advisors (Chernomyrdin 1994, Gowan 1995, Lavigne 1999, Schuler 1998). This doctrine decreed that economic restructuring and sustainable income growth could be attained through a re-orientation of macroeconomic signals alone, with a private sector acting as the engine to growth (Sachs and Lipton 1991, Lavigne 1999, Schuler 1998). The neo-liberal consensus envisaged the role of the government to be limited to the creation of a 'level playing field' in which no sector or firm is privileged in any way whatsoever. The emphasis on the three 'zatsias' (*privatizatsia, liberalizatsia, demokratizatsia*) effectively precluded considerations of alternative approaches to transition (Lavigne 1999, Smith and Pickles 1998).

More recently, however, the neo-liberal hegemony has been challenged as the policy prescription derived from it have been inadequate in addressing some of the fundamental economic and social problems facing the countries in the region (Amsden et al. 1994, Gowan 1995, Hardy and Rainnie 1996, Smith and Pickles 1998). The early years of transition produced unprecedented declines in output, rising unemployment and increasing income inequalities. Even though some of the macroeconomic indicators have improved over the recent years, the persistently low competitiveness of the countries in the region puts into question the long-term sustainability of growth (Grabher 1997, Knell 1996, Myant 1997). Privatisation and enlightened macroeconomic policies are necessary but not sufficient prerequisites for economic restructuring (Audretsch 1993).

The neo-liberalist dualism separating the state from markets has also increasingly been viewed as flawed. Evolutionary economists have highlighted the existence of a diversity of governance mechanisms arising in a path-dependent fashion (Grabher 1992 and 1997, Murrell 1990, Smith and Pickles 1998). Institutionalist economists have argued the importance of strategic government intervention at the macro-, meso- and micro-levels of the economy in order to instigate economic development in the region (Amsden et al. 1994, Chang 1996, Knaack 1996, Knell 1996, Kozul-Wright and Rayment 1996).

The promotion of small firm development has emerged as a key item on the economic policy agenda in Central and Eastern Europe. Small firms are increasingly considered to be a key mechanism for the instigation of structural change in the economies of the region (Johnson and Loveman 1995, Sutherland and Hanson 1996). In addition, they are expected to contribute to new job creation, innovation and exports (Audretsch 1993, Batyaeva 1994, Boeri 1994, Dyker and Perrin 1997, Ioffe et al. 1996, Johnson and Loveman 1995, McDermott and Mejstrik, Smith 1998). Further, there is recognition that because small firms are in some sense 'disadvantaged' due to their size and their relative lack of power in the market, government policies need to be developed in order to foster the emergence of small firms (Blinov 1994 and 1996, Chepurenko 1996, Ermakov 1995, Ioffe et al. 1996, Kozak 1996, Vilkov 1996, Zloch-Christy 1998). Given the lack of experience in SME development, governments within the region have been ready to adopt 'best practice' policies from developed market economies in Western Europe and the rest of the world (Gibb and Haas 1996). This raises a number of questions. In particular:

- what is best practice' policy and how easily can it be transferred?
- will such policies be equally successful in the East European context which differs in many instances radically from environments observed in Western Europe?
- to what extent do policies need to be adapted to local contexts?

This research seeks to contribute to the literature on economic transition in Central and Eastern Europe by shedding light on the emergent small firm policy debate in Eastern Europe in the light of relevant theories. In particular, it seeks to establish the reasons for and extent to which policy experience from the West is transferred to Eastern Europe. The relevance of such policies to the Eastern European transitional context will be evaluated. A key focus of the analysis is local-level policies because within post-communist countries considerable regional economic divergences exist which might require policy adaptation. Furthermore, small firm policy is often a key component of local economic strategies. Also, national-level policy frameworks might devolve implementation of policies to the local level. Thus the thesis aims to systematically study small firm policies in two transition economies, Russia and Hungary, and regions within these two, and assess the relative appropriateness and relevance of policies in the light of the different prevailing environments.

The first chapter focuses on methodological issues. It seeks to explain the value of a comparative analysis as well as the selection of the two transition economies and case study regions within these. The chapter furthermore analyses the reasons for and value of qualitative methodologies that have been used in this thesis. Questions of policy evaluation are also addressed. The chapter seeks to highlight not only general methodological problems in the field of small firm policy research but also the specific issues that arise from conducting this kind of research in Eastern Europe.

Chapter 2 presents an examination of the theoretical positions in respect of small firm policies. It charts the various theoretical underpinnings of small firm policies and examines their relevance to the policy debate in Eastern Europe. The chapter introduces also a conceptual framework for the study of small firm policy based on objectives, instruments, levels and target groups.

Chapter 3 seeks to address the question of what constitutes 'best practice' in small firm policy in the West European context, and if such 'best practice' experiences can be readily transferred. Three 'models' of small firm development - the Mondragon, Emilian and West Midlands models - have been selected for closer analysis. The chapter explains the selection of these models and, on the basis of a literature review, analyses their key parameters and possibilities for transfer.

The fourth chapter summarises the transitional policy agenda in Central and Eastern Europe and the position of small firms and small firm policy within it. It argues that small firms have a very important role to play in initiating restructuring at the microlevel and in contributing to the attainment of macroeconomic stabilisation during transition. The structural weaknesses that the small firms sector exhibits in many countries provide a strong arguments for more, rather than less, government intervention.

Chapter 5 analyses small firm development in Russia and Hungary. It outlines the differences in terms of growth dynamics of small firms, the size of the small firm sector and the role that small firms play in these two economies. These differences might have been expected, given the different approaches to and progress in transition in Russia and Hungary. However, the chapter also outlines similarities in small firm development between the two countries and argues that these might be viewed as transition-specific concerns in the development of small firms.

Chapter 6 compares national-level small firm policies in Russia and Hungary. It analyses similarities and differences in respect of the rationale for small firm policies and regards the objectives and instruments. The analysis highlights that Hungary's small firm policies have been more strongly influenced by Western policy experience, whereas Russia has sought to develop 'home-spun' solutions. The chapter concludes by

looking at the relevance and appropriateness of the emerging policies in the two countries.

Chapter 7 analyses the development of small firm policies in the four case study regions in Eastern Europe - Budapest and Szabolcs- Szatmár-Bereg in Hungary and Moscow and Tyumen in Russia. The comparative analysis of the local experience in the development of small firm policies reveals significant inter-country, rather than intra-country, differences which is explained in the light of the strong central influence on policies in the regions. The chapter argues that this lack of local adaptation is a serious shortcoming of emerging policies in Eastern Europe.

Chapter 8 summarises the findings as regards small firm development and small firm policies in Russia and Hungary. It compares the experience of Eastern Europe with the 'models' of small firm development as outlined in chapter 3. The chapter argues that Eastern Europe represents a special case of small firm development on account of the significant differences between the case study regions in Eastern Europe and the West. The policy transfer from the West to the East, and especially the strong neo-liberal influences of the UK experience on Hungary's small firm policies, has not been very successful as it failed to neglect local specificities. The chapter concludes by articulating possible policy alternatives based on a variant of institutional economics - the industrial district thesis. The benefits and drawbacks of transferring this type of policy experience to Eastern Europe will be given thought.

# Chapter 1: Methodology

## 1.1. The research problem

The promotion of small firms has emerged as a key policy item on the transitional reform agenda in Central and Eastern Europe as policy-makers have realised the importance of small firms in initiating structural change. The international donor community has extensively influenced and supported this agenda through technical assistance and other means of international aid (Bateman 1999, Batstone 1997, Gibb and Haas 1996, Wedel 1998). But whilst there has been a proliferation of research on the nature, the scale and scope of emerging small firms and entrepreneurship in the region (see for example Acs and Audretsch 1993, Bartlett and Hoggett 1994, Brezinski and Fritsch 1996, Grabher and Stark 1997, Johnson and Loveman 1995, Webster 1992), thus far little systematic research has been carried out in respect of the evolution, nature and efficacy of the emerging policies, both at the national and the regional/local levels, supporting small firm sector development and growth.[1] In the absence of, on the one hand, domestic experience in the formulation and implementation of small firm policies and, on the other, the significant technical assistance efforts of the donors, there is a tendency for 'best practice' policies from the West to be transplanted in Eastern Europe (Batstone 1997, Gibb and Haas 1996). Yet the often radically different environment in Central and Eastern Europe and the differences prevailing between countries and regions within these countries, might render such 'successful'[2] Western policy examples ineffective if not adapted to local conditions. This thesis therefore seeks to ascertain, firstly, the extent to which Western policy experience has influenced and framed small firm policy developments in Central and Eastern Europe. To that end, three 'models' of

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[1] PHARE has only in 1998 launched a comprehensive assessment of its support for small firm sector development in Central Europe (DG1A Evaluation Unit "Evaluation of PHARE SME Programme Support in the transition economies of Central and Eastern Europe", European Commission, Brussels).

[2] Indeed, some authors have questioned the existence of an ideal model of good practice in SME promotion in Western market economies (see Gibb 1995 as quoted in Batstone 1997). The issue as to what is 'best practice' will be returned to in chapter 3.

small firm development in Western Europe have been selected (the Emilian model, the Mondragon model and the West Midlands model - see chapter 3) and their transferability and degree of transfer to the transitional economies studied. As Gibb and Haas (1996) note, the transfer of policy experience is unlikely to be a pure 'cloning' of Western institutions if only because of the wide range of Western consultants advising East European policy-makers and a certain degree of 'learning by doing'. The issue then arises as to the factors influencing such adaptations. The second question addressed by this research is whether these policies are relevant, in terms of their objectives and instruments, to the environment prevailing in Central and Eastern Europe and, therefore, whether they are appropriate for the stimulation of a sustainable small firm sector in the region.

## 1.2. Why Russia and Hungary?

The research focuses on two transitional economies, Russia and Hungary. These countries exhibit considerable differences in economic, political and social terms. Hungary, with its more recent history of capitalism to 1949 and the subsequent legacy of pre-transition reforms from the 1960s onwards, embarked on a gradual approach to transition. It is now widely considered to be one of most economically successful transition economies (EBRD 1997, Halpern and Wyplosz 1998), with first-wave membership of the European Union expected in the near future. Russia, on the other hand, is experiencing a recession of gargantuan proportions, following the attempts at implementation of 'shock therapy' in an economy deeply marked by the structural and cultural legacy of 60 years of central planning (Hedlund 1999).[3] These differences in economic environments and market structures are, ceteris paribus, likely to influence the emergence of small firms in the region and determine the dynamics of the sector (see also Bartlett and Hoggett 1994 for a comparative empirical study on small firm

[3] For a more detailed analysis of the economic conditions in the countries see chapter 5.

development in Hungary, Slovenia and Bulgaria). The more progress on transition which is made, and the more an economy has progressed to 'market-type' systems, the greater will be the convergence towards the types of small firm environments found in such systems, thereby providing a potential basis for policy transfer. However, even if systemic barriers to policy transfer are alleviated, specific local conditions can hinder successful implementation (see 1.3.). A further benefit of a comparative study lies in the lessons gained from small firm policy development and implementation in one of the early reformers (Hungary) and in a late reformer (Russia).

A second consideration for the selection of these two countries arises from the involvement of the West (and in particular the major donors, both bilateral and multilateral) in the region. Hungary, along with Poland and the former Czechoslovakia, as the transitional forerunners, were the first countries in receipt of international donor assistance, including technical assistance for small firm development. Furthermore, Hungary has been invited to join accession negotiations with the European Union which entails the approximation of Hungarian legislation and policies to EU ones. For these reasons there is a greater likelihood that small firm policies developed in Hungary are influenced by Western models, whereas Russia's relative isolation might lead to a search for alternative, home-spun solutions.

A final and more practical consideration is that the research builds on established research contacts, arising from previous academic collaborations with universities and research institutes in the region. These contacts not only provided some logistical support but also facilitated identification of and access to interviewees (see 1.6. for a further discussion on the problems of interviews).

## 1.3. Selection of case study regions

The research focuses in particular on the study of small firm policies at the local level in the selected transitional economies for a number of reasons. Firstly, the operationalisation of small firm policies developed at the national level is frequently devolved to the local/regional level because local governments are deemed to utilise resources more efficiently than central governments as information assymetries are narrowed (Newlands 1995, for a more detailed discussion of the theoretical problems see chapter 2). The constraints and opportunities that such an approach generates merit studying from a local viewpoint. Secondly, local governments themselves are likely to incorporate small firm promotion into local economic development strategies as small firms hold the promise of indigenous growth opportunities (Eisenschitz and Gough 1993, Hardy and Rainnie 1996, Smith 1998). Again, this warrants a local perspective on the study of policy. Lastly, the local focus is relevant because of the increasing economic divergences within post-communist countries (Smith 1998). The Russian Federation, for example, exhibits a wide range of diverse economic environments in terms of industrial structures, incomes and growth (Bylov and Lavrov 1996, Bradshaw et al. 1998, Sutherland and Hanson 1996). Even in a smaller country like Hungary there has been, since 1990, an increasing trend towards spatial economic divergence (Barath and Szalo 1990, Horvath 1995). The result has been the development and/or entrenchment of distinct local economic environments which provide differing stimuli and barriers that shape the size and structure of the emerging small firm sector. Any effective small firm policies need to take account of such differences in the milieux of entrepreneurship.

One problem with this approach, however, is the selection of the number of localities in the target countries as a survey of small firm policies in all of the regions in Russia and Hungary would exceed the scope of this thesis. Therefore, key analytical parameters for

selection and comparison had to be established, bearing in mind the need to compare 'like with like', and also the desirability of including a variety of contrasting regions to establish the extent to which policies need to be tailored to particular local conditions. Following a literature review, three stylised features - spatial, sectoral and endowment of natural resources - were identified as factors that are likely to shape local economic development in general and small firm development in particular in the two transition economies. Whilst these parameters do not fully capture the diversity of local economic environments emerging in the transition economies (for example, a further breakdown might include particular industrial profiles or high versus low unemployment regions), they nevertheless cater for a cross-section of regions in the two countries (see also Curran and Blackburn 1994 on case study methodology).

Based on this typology and following a literature review, two case study regions in each country have been selected for detailed analysis:

Table 1.1: Typology of selected case study regions

| **Stylised features** | **Hungary** | **Russia** |
|---|---|---|
| **Spatial** | | |
| central | Budapest | Moscow |
| peripheral | SSB | Tyumen |
| **Sectoral** | | |
| industrial | Budapest | Moscow, Tyumen |
| agricultural | SSB | |
| **Natural Resources** | | |
| rich | | Tyumen |
| poor | Budapest, SSB | Moscow |

The case study regions include representatives of central and peripheral regions (Budapest and Moscow versus Tyumen and Szabolcs-Szatmár-Bereg), industrial and agricultural regions (Moscow, Tyumen, Budapest versus Szabolcs-Szatmár-Bereg) and resource-rich versus resource-poor regions (Tyumen versus Budapest, Szabolcs-Szatmár-Bereg and Moscow). Whilst not capturing the whole diversity of localities, valuable insights in respect of policy application can nevertheless be drawn from the intra- and inter-country observations and comparisons of these case studies.

## 1.4. Policy evaluation

The thesis is concerned with assessing whether the emerging small firm policies, transplanted or home-spun, are in some sense 'successful'. A focus of the thesis is, therefore, on policy evaluation in the countries, via the case study regions outlined above. Yet, as Turok (1997) points out, such evaluation

> ...is particularly difficult because of the intangible and indirect nature of many forms of business support (information, advice, training); their minor influence in relation to other, more powerful forces affecting SMEs; the uncertain timing and duration of their effects; the difficulties of tracing through and measuring the impact of support on ultimate indicators of company performance such as jobs and turnover; the technical complexity of trying to estimate displacement and multiplier effects; and the changing influence of external environmental conditions. (Turok, 1997, p.338)

The conventional approach to measuring the 'success' or 'failure' of policies is to assess their effectiveness, that is to measure inputs and outputs of particular policies in the light of defined targets. As Storey (1994) argues, such an analysis is fraught with problems as the targets of particular policies are often not clearly defined and outcomes are difficult to measure due to displacement[4] and deadweight[5] effects (see also Coulson

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[4] Displacement occurs when established, non-subsidised firms are pushed out of the market as a result of the entry of new, subsidised firms.

1990). In the context of Eastern Europe, such an approach poses particular problems due to the uneven availability and the lack of reliability of official statistics (Voronkov 1998). As regards small firms, for example, statistical offices in the past had no call to collect data given the relative absence of such enterprises in the economy. Only recently have methodologies and systems for data collection been elaborated and, given the fluid nature of the transitional environment, these have frequently been revised (KSH 1994). The reliability of these data also has to be scrutinised given the reported reluctance of small enterprises to provide information on their activities (Kallay et al. 1996, OECD 1998) and the insufficient 'cleanness' of databases which often include phantom companies or companies that have ceased trading after the census date (Kallay 1997).

An assessment of effectiveness would also require large-scale longitudinal surveys of small firms which, in addition to output indicators, would need to seek to measure the above mentioned deadweight and displacement effects. Such surveys are notoriously difficult to carry out in Eastern Europe given the lack of databases from which a representative sample can be drawn. The researcher would then have to model what would have happened in the absence of policy intervention, a task which is fraught with numerous problems given the numbers of factors affecting small business development (Coulson 1990, Turok 1997). Furthermore, the breadth of such an inquiry poses formidable logistical obstacles to this survey approach.

The measurement of effectiveness also presupposes a knowledge of the policies in terms of their objectives and instruments. However, objectives of policies often tend to be ambiguously defined which complicates evaluation (Coulson 1990, Eisenschitz and Gough 1993, Storey 1994). Furthermore, policy objectives do not tend to be static, rather they might evolve over time in response to the changing external environment

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[5] This is the problem of the free-rider, i.e. entrepreneurs partaking in a support programme because it is available. Any assessment of the effectiveness of policies needs to take account of what would have happened in the absence of the support measures.

(Coulson 1990). In the case of Eastern Europe, as was highlighted above, such information in respect of objectives of policies and their evolution is only available incompletely and is in itself the subject of this study.

Some studies have sought to evaluate small firm policies by distinguishing between output (data on the numbers of companies assisted and the value of that assistance) and outcome (the wider impact in the context of objectives) (Kozak 1996). However, findings from such evaluations still tended to be strongly biased towards output data, which are relatively easy to measure. The conclusions that could be made regarding the impact were relatively weak since the variables impinging on this measurement were numerous and significant.

Studies from donor organisations seeking to evaluate the success of policies have focused on, in addition to output data (how many enterprises were assisted), the "profitability" of the scheme (Zeitinger 1996). This reflects the prerogative for accountability and transparency of the donor community but neglects the possible wider impact of policy measures as a form of externality. The real "additionality" or value-added of policy measures is not captured in this measurement approach.

A more sophisticated approach towards policy evaluation was attempted by Orser and Hogarth-Scott (1998) on Canadian SME programmes. They sought to investigate through case analysis the findings of programme reviews drawing on a multiplicity of methods including interviews, participant observation and archival data. However, given the paucity of policy evaluations in Eastern Europe, an approach based on validation of previous research is impractical at this stage.

One of the common problems of policy evaluation studies is the degree to which 'value-added' is measured. As Gibb and Haas (1996) and Johannison and Nilsson (1989) argue, 'value-added' in a broader sense includes not only the direct value that is added to the recipient (small businesses) but includes the value-added through networking in the

local community. This might involve the increased efficiency and effectiveness of key stakeholders in small firm development (banks, large firms, etc.), other small business support institutions, and also the greater embeddedness of small firms in the wider community and its resultant impact on the local business culture (Gibb and Haas 1996). An evaluation of the 'success' of policies therefore has to take account of the networking effect.

Difficult though evaluation is, it is a necessary part of this thesis and therefore a range of indicators will be used to see if policies are in some sense 'successful'. The study seeks to evaluate small firm policies in terms of their appropriateness, that is the extent to which policies address the specific weaknesses of small firms in the locality and the degree of embeddedness of policies. As such, this investigation closely follows qualitative methodologies seeking to evaluate networking impact that have been used by small business researchers (Curran and Blackburn 1994, Gibb and Haas 1996, Johannisson and Nilsson 1989), regional policy analysts (Syrett 1995) and social anthropologists evaluating international aid programmes (Wedel 1998, Bruno 1998). In particular, it seeks to ascertain whether institutions create successful small firms (narrow value-added) or successful small firm policies (broader value-added). Criteria for assessment include:

- activity measures (forms of support, number of firms supported)
- the extent to which weaknesses of the local small firm sector have been identified and how far these weaknesses are addressed
- what linkages are established with key stakeholders in the community

Thus, although some use will be made of quantitative methods, greater emphasis is placed on qualitative approaches. These are discussed below.

## 1.5. Qualitative methods

Qualitative methods have been increasingly used in the social sciences as a way of enhancing our understanding of meanings and interrelationships (Dey 1993, McCracken 1988). However, as Silverman (1997) notes, the method adopted needs to be appropriate to the research problem which is being tackled. A number of strengths of qualitative data are relevant to this study. Qualitative data have a strong 'local groundedness' where "...the influences of the local context are not stripped away, but taken into account." (Miles and Huberman 1994). Any evaluation of the nature and impact of local small firm policies needs to take account of such local factors. Furthermore, qualitative data provide 'thick descriptions' (Dey 1993) with a potential for revealing complexity (Miles and Huberman 1994). As such, qualitative data will further our understanding of the nature and context of emerging small firm policies and shed light on their evolution and the factors that have influenced it. Lastly, McCracken (1988) notes that qualitative methods are more useful when the respondent is less likely to answer readily and unambiguously, that is, when the answer is more complex and involves a certain degree of difficulty and imprecision. This is of relevance to this research since categories related to small firm policy might be ambiguous to the respondent. Storey (1994), for example, demonstrates ambiguity in respect of objectives of small firm policies. The reduction of unemployment or increase in small firm employment are casually used synonomously whereas they constitute two very different outcomes. Furthermore, as the development of small firms and small firm policy is a relatively new concept in the transitional economies, there is likely to be a degree of ambiguity as regards basic concepts which can only be adequately explored via qualitative methods.

## 1.6. The comparative analysis - data collection, reduction and display

The main data used in the research derive from three sources. Firstly, an extensive literature review of small firm policy, of the nature of transition and of small firms in transition economies has been carried out. This has helped to highlight the assumptions about small firm policies in transition economies and their role within the standard policy arsenal of transitional reform. Furthermore, the literature search yielded quantitative data both in the form of official, aggregate statistics and also surveys that sought to identify characteristics of small firms in the countries. The data thus derived has been used further to analyse the validity of the findings generated from the other sources.

The second source of information has been policy documents and related texts. The majority of institutions, especially governmental bodies and international donors, have produced a variety of documents in which details of policy strategies and measures, as well as evaluations of progress, are outlined. Those documents were subjected to content analysis with a view to eliciting categories and themes in policy-making. As Miller (1997) argues:

> At minimum, institutional texts may be implicated in public debates as sources of 'factual' information about the issues in debate or as reports on institutional actors' success in fulfilling the aims of the public policies that they are required to implement. (Miller, 1997, p.90)

Apart from the factual information that such policy documents yield, they are also important in highlighting policy priorities and policy approaches. Content analysis of policy documents is therefore an important means of furthering our understanding of policy discourse in transition economies.

The main data are derived from interviews with 'stakeholders' or 'problem owners' (Herlau and Tetzschner 1994) in small firm policies. 'Stakeholders' are those individuals who are either directly or indirectly involved in decision-making and/or affected directly or indirectly by the policy measures. As 'stakeholders' they are able to provide various insights in respect of the nature and evolution of policies, of the setting of small firm policy in the wider policy framework and of the relevance of policies to the locality. Thus, the key informants can potentially provide rich contextual data.

Three main groups of informants were identified. The first group is policy-makers. This group is very diverse as it includes decision-makers both at the national and local levels, governmental bodies, non-governmental organisations and international donors active in the field of SME promotion. A core group of policy-makers was initially identified following the literature review which identified some of the policy-making bodies in the case study areas. These included the Hungarian Foundation for Enterprise Promotion (MVA), the Institute for Small Business Development in Budapest, the Foundation for Market Economy Budapest, the Primom Foundation for Enterprise Promotion Nyíregyháza, Chambers of Commerce in the four regions, the Anti-Monopoly Commission of the Russian Federation, Moscow city government and Tyumen administration and the State Committee for the Support of Small Entrepreneurship in Russia. Subsequently the research in the field enabled the identification of additional policy-making bodies and institutions which had not been identified through previous desk research, including local small business associations, technology parks and local governmental departments dealing directly or indirectly with SME support. In order to avoid 'elite bias' (Miles and Huberman 1994) deriving from an overrepresentation of high-status policy-makers (such as heads of institutions), lower status representatives, including people involved in the day-to-day work with small firms, were included. The information derived from these informants, however, is essentially top-down and represents policy-making as viewed from a distinct interest group, that is, those that are formulating policy.

The second group of key informants was small businesses themselves, as the recipients of policy. Here the approach was to include both actual recipients of policy measures, such as small businesses located in incubator houses, technoparks or recipients of subsidised loans, as well as small firms that have not been in receipt of small firm policy measures. The inclusion of this 'non-recipient' group of firms is necessary in order to attain a less biased view on the role and impact of small firm policy in the locality. The latter group is also the larger one since surveys indicate that only a small percentage of small firms is in receipt of assistance (Avilova et al. 1995). This facilitates a degree of representativeness.

The last group of informants can be described as 'objective outsiders' - in particular, academics in the region who are involved in research on economics and small firm issues. As such, they are able to provide an outsider's perspective (not being directly involved in the policy process) combined with an insider's knowledge of the local economy and small firms within it. During the actual field work it emerged, however, that the distinction between the three groups of key informants was somewhat blurred. For example, some of the 'objective outsiders' were involved in an advisory capacity to policy-makers or involved in running a small business themselves. Some of the policy-makers also owned and managed a small business. The classification used here is largely based on self-definition of the respondents, i.e. what the respondents saw as their main occupation.

Altogether, a total of nine and twelve weeks was spent in Hungary and Russia respectively, between 1993 and 1997, on field research. This was divided between visits lasting a minimum of one week and a maximum of six weeks. In total, 77 interviews were carried out comprising of 49 with policy-makers, 16 with academics and 12 with small business owners (for details on interviewees see appendix 1).

Long, semi-structured interviews were used as the main method for data collection. Oppenheim (1992) argues that the value of such in-depth interviews lies not only in their capacity to collect data but also to collect ideas. For McCracken, in-depth interviews are essential in understanding how respondents view reality. The use of a semi-structured interview is useful as it provides a more comprehensive structure, focus and objective to the interview whilst at the same time enabling a degree of 'open-endedness' which can elicit exploratory responses from the interviewee and thus reveal new areas of exploration that had not been previously considered (Minichiello et al. 1995). The scheduled interviews, which incorporated descriptions of the respondents operations, focused questions on the following key areas:

- background information on the economic situation of the locality
- obstacles to small firm development in the region
- the background, evolution and structure of the institution
- the nature of the policy (context, objectives, instruments)
- linkages between support structures and small firms

The general schedule was adapted to the various informants depending on their 'stakeholder' nature and their position within, and their relation to, the organisation. Thus, in interviews with high-level policy-makers, for example, more in-depth questioning on strategic issues occurred whereas small-firm representatives were questioned in more detail on the environment within which their business was operating. The interviews typically lasted two hours and, with some exceptions[6], were recorded and later fully transcribed.

The interview method posed a number of problems. Firstly, the key informants needed to be identified and interviews arranged. Whilst policy-makers and academics were, by

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[6] Some interviewees expressly asked not to have the interview tape-recorded. The issue of confidentiality that arises here will be returned to below.

and large, easily accessible, small business owners were more difficult to involve as the research entered into the 'privacy' of their livelihoods. As social anthropologists working in Eastern Europe have shown (Bruno 1998, Wedel 1998), informants tend to be suspicious of the motives of researchers and are reluctant to be open and forthcoming with information. What is required is the establishment of trust towards the interviewer which can also be achieved by being introduced via a 'trustworthy' intermediary. In this way, distance between the interviewer and interviewee can be maintained without destabilising the delicate investigator/respondent relationship (McCracken 1988). Following this approach, most of the small business-owners were contacted via established links with academics, friends and, in the case of policy recipients, the policy-delivering institution. The identification of informants, therefore, became something of a process whereby interviews yielded not only data but also contributed to the widening of the circle of informants. Some of the informants, furthermore, requested that the information given would be used only for the thesis and not for publication in Journals or newspapers. This commitment to source protection is not uncommon in social science research (see for instance Wedel 1998) as it is often the only way of obtaining information which is viewed by the respondent as sensitive. In the context of this research, two problems of confidentiality arose. Firstly, there is the issue of business confidentiality. Small business owners were concerned about providing information which is sensitive to their survival and growth. For example, information on costs and pricing were disclosed only when the respondent had satisfied him/herself as to the purely academic use of such data. Secondly, in a particularly Eastern European context, respondents expressed concerns as to who would have access to the data provided during the interviews. Small business owners were concerned that information on their activities might fall into the hands of criminal groups or the tax inspector. Some policy-makers, on the other hand, requested confidentiality as their views on policies did not coincide with the official institutional line. In many cases, the need for confidentiality was more imagined than real, however, it had to be respected in order to

gain a fuller and more balanced insight into the problems of policy development in the case study regions.

Secondly, interviews required a substantial investment of time on the part of the key informants. Policy-makers, in particular, were frequently under pressure given their often high-level responsibilities. As Wedel (1998) has noted in a study of foreign aid in Eastern Europe, various layers of governmental and non-governmental institutions commit a substantial amount of their time to fact-finding missions by foreign experts and consultants advising on transition. They are doing so with increasing reluctance since the tangible benefits derived from these activities are often minimal to the East Europeans.[7] The small business owners, on the other hand, need to find time within their busy schedule of the day-to-day running of a business. Despite these real and anticipated constraints, the interviewees were, by and large, very forthcoming, especially welcoming the opportunity of talking about various aspects of their work. In many cases, I was asked to continue the interview at another date in order to discuss some aspects more fully.

Thirdly, in Hungary, language problems were anticipated. The use of an interpreter in an interview is suboptimal as meanings might be lost in the translation. However, the majority of key informants spoke either English or German and only in a limited number of cases was an interpreter required. In Russia, all interviews were carried out in Russian since the researcher spoke fluent Russian.

Fourthly, problems can arise in interviews due to obtrusiveness by the researcher ('active listening') and lack of distance (McCracken 1988). An attempt was made to minimise the degree of obtrusiveness (suggestions of categories by the researcher) by the use of the semi-structured questionnaire which included prompts for the various

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[7] The issues around 'consultant fatigue' will be explored in more detail in chapter 6.

categories for consideration. Distance was created through the operation in a culture different to my own. However, sometimes during the interviews, respondents inquired about my own experiences. Questions such as "And what is the experience of that in your own country?" were posed as the informants, especially small business owners, sought to retrieve information from the researcher. This infringement on distance, however, was important as it further established a link of trust, and respondents frequently followed it up by relating, in more detail, their own experiences.

Lastly, long interviews are very strenuous for the researcher since, as well as recording the information given, new avenues of enquiry are often opened up during the interview process which require additions to the interview schedule. At the same time, misunderstanding and/or incomprehension between researcher and informant across a linguistic divide, has to be minimised (Oppenheim 1992). As McCracken so aptly notes,

> There is virtually no opportunity for unhurried identification or reflection. There is also the pressing knowledge that this opportunity will never come again. What the investigator does not capture in the moment will be lost forever. This is a challenging occasion because mistakes are easy to make and impossible to rectify. (McCracken, 1988, p.38)

The next analytical step in the research process was data reduction and display. Data reduction is a process that is carried out throughout the fieldwork as the semi-structured interview schedule already focuses on various categories, thus condensing data (Miles and Huberman 1994, McCracken 1988, Dey 1993). Nevertheless, the tape transcriptions yielded a wealth of data that needed to be further reduced. To that end, the data was organised by clusters and themes, and summaries were used to further condense the findings into manageable categories. Normally the practice is for such data to be displayed as text or assembled in graphs, tables and matrices (Miles and Huberman 1994). In this study, text has been used to describe, in-depth, key policies, organisations

and institutions and tables and organisational charts have been used to highlight linkages between institutions in a particular context to demonstrate networking effects.

## 1.7. Testing and verification of findings

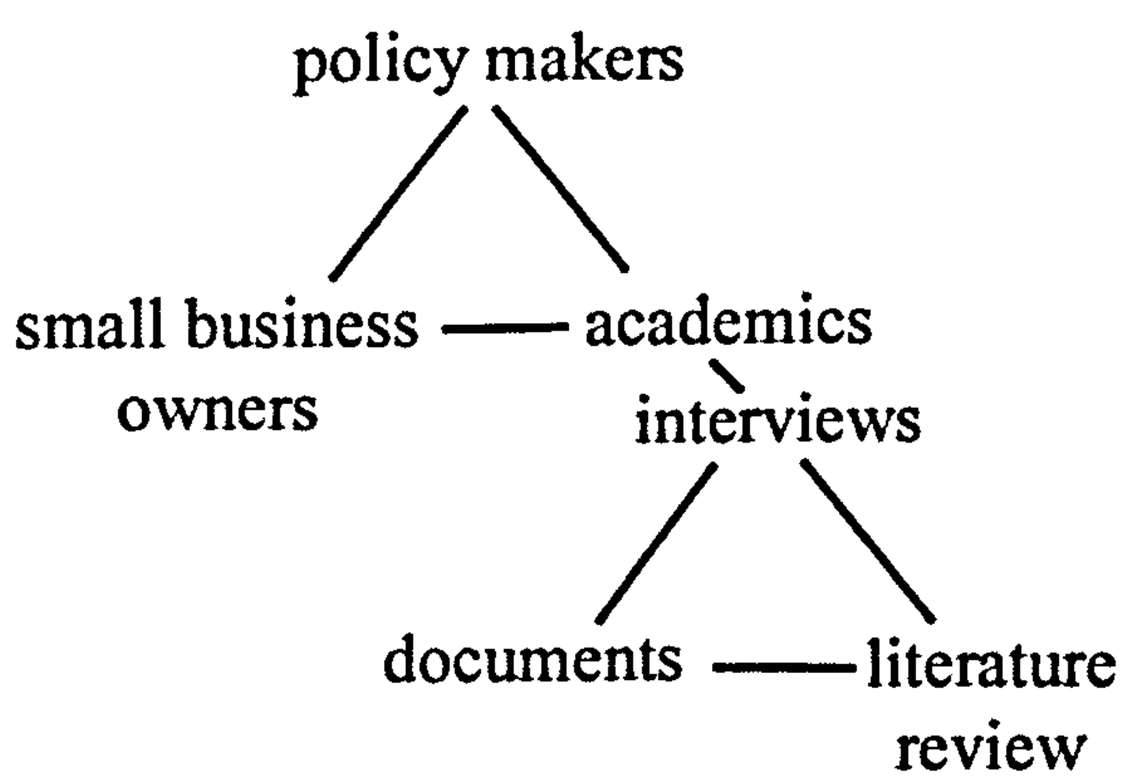
There are various methods at the researcher's disposal to test the validity of the research findings. Research can be replicated, but this can be difficult since the context and setting of research may not be duplicated at a different point in time. Even attempts to replicate quantitative studies can be fraught with difficulties given the different assumptions made by researchers (see Storey 1994 on the replication of the Birch job generation study in small firms). Bloor (1997) suggests two alternative ways of validating research findings. One such approach is 'member validation' where research findings are validated "...by demonstrating a correspondence between the researcher's analysis and collectivity members' description of their social world." (Bloor, 1997, p.41). Essentially it seeks to demonstrate that findings taken back to the field are understood and accepted as descriptions by the members of the collectivity (see Orser and Hogarth-Scott 1998 for an example of this approach).

The second, more common approach, is triangulation which involves the testing of the research findings against other, already validated findings. Triangulation can take various forms, including triangulation by data source, by method, by researcher, by theory and by data type (Miles and Huberman 1994, Dey 1993). Triangulation thus seeks to provide corroborating evidence to the research findings. Problems might arise, however, if the evidence is contradictory. This may not, in itself, invalidate the research since, as Bloor (1997) notes, findings collected by different methods are rarely perfectly comparable. Moreover, such contradictions might help in framing future research agendas that can further our understanding of particular questions and issues. Thus, triangulation has to be viewed as a means of seeking corroborating evidence, noting

inconsistencies and contradictions and seeking to explain those in the context within which they are derived thus decreasing possible bias (Minichiello et al. 1995).

For the purpose of this research, triangulation by data source, that is information provided by different groups of informants, and by data type (qualitative data derived from interviews and policy documents and quantitative data from primary and secondary data sources) has been used to validate findings.

Diagram 1.1: Triangulation of data




1.8. Conclusion

This research seeks to describe small firm policies in the transitional economies of Russia and Hungary at the local level and analyse the degree to which policy experience from Western Europe has been 'successfully' transferred. By comparing two countries and localities within them, lessons can be drawn as to the degree to which policies are adapted to the specific local conditions and indeed the need for doing so. The research is essentially qualitative in nature as it seeks to go beyond the simple measurement of input and output data as used by some quantitative studies (for example Kozak 1996,

Zeitinger 1996) and look instead at how relevant policies are to the environment within which they are operationalised. Thus, an evaluation of the broader networking effect of policies is sought, generating both theoretical and policy implications in this research context.

## Chapter 2: Small firm policy: some theoretical and practical considerations

This chapter seeks to develop a framework for the analysis of small firm policies that will enable international comparisons in later chapters. I start by outlining some of the problems in respect of definitions of the recipients of small firm policies and look at the distinctions between small and large firms from both qualitative and quantitative perspectives. Second, the rationale for small firm policy within economic theories and in actual practice will be explored. At this point it is useful to take a closer look also at the definition of small firm policies, and their position within the wider economic policy framework. Since this research is concerned with small firm policies in Eastern Europe, the transition-specific context of such policies will be highlighted. Having established the 'why's' of small firm policy, the last section will turn to the 'how' by reviewing the objectives, the instruments and the levels at which small firm policies are applied.

### 2.1. Small firms: definitional issues

Definitional issues continue to vex the researcher into the small firm sector. In attempts to measure and quantify the size, role, growth and other features of the small firm sector, researchers have assigned quantitative variables, such as number of people employed, turnover or assets, to define a small firm (Stanworth and Gray 1991). Yet, even the casual observer would agree that a firm with, say, 200 employees, while small by the standards of the automotive industry, would be a different proposition in hairdressing. Bannock succinctly summarises this dilemma:

> No simple definition of what constitues a small firm can be useful for all purposes. A window cleaner with a bucket; an independent shop with two employees; a farmer with 300 acres, one employee, a tractor and other equipment; a clothing manufacturer with fifty employees; all share some common problems which are essentially different from those of a multinational company. (Bannock 1991 as quoted in Curran and Blackburn, 1994, p.55)

The result of such differences in, for instance, capital and labour intensity, has led to the emergence of a myriad of definitions attempting to quantitatively capture the specificities of small firms in a variety of sectors (Storey 1994). However, whilst those definitions allow for a closer examination of small firms in particular industries and sub-sectors, cross-industrial or even cross-national comparisons are fraught with difficulties. The need for such kinds of cross-national comparative data has led the European Union to adopt a simplified definition based on employment criteria only.[1]

However, the notion that a small firm is simply a scaled-down version of a large firm is somewhat unsatisfactory (Storey 1994) as it fails to capture some of the behavioural and cultural features that distinguish small from large firms (Curran and Blackburn 1994). Edith Penrose, in her seminal work on the theory of growth of firms, noted that "...we cannot define a caterpillar and then use the same definition for a butterfly." (Penrose, 1980, p.19). Seeking to capture some of the qualitative differences between large and small firms, the UK's Bolton Report (1971), a widely influential study undertaken into the role of the small firm sector in the UK economy, only partially succeeded in reconciling its economic definition with its statistical one based on quantitative variables (Storey 1994). Later research showed that, for example, firms between 10-20 employees tend to develop management structures (Atkinson and Meager 1994) which are involved in executive decision-making.[2] It has also been shown that many small firms occupy niche markets in which, despite their small size, they are market leaders, sometimes on a global scale (Storey 1994, *The Economist*, 2nd March 1996).

Wynarczyk et al. (1997) explore these qualitative characteristics further concluding that there are three significant distinguishing characteristics between small and large firms. Firstly, small firms experience a greater external uncertainty of the business

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[1] The definition breaks down into a number of categories: microenterprises with up to 10 employees, small enterprises with up to 100 employees and medium-sized enterprises with up to 250 employees.

[2] According to Bolton's qualitative, or economic, definition, small firms (as opposed to large firms) exhibit an absence of a formal managerial fiat, occupy a small share of the market only and are not partially or wholly-owned by a larger firm.

environment and are less able to hedge against external disturbances. A second, related feature is that the evolution of small firms is much more 'stormy' than the conventional growth, either organic or through mergers and acquisitions, of large firms. The last difference, highlighted by Wynarczyk et al. (1997), relates to the different approaches to innovation observed in small and large firms. This observation finds support in a study by Rothwell and Dodgson (1994) which concluded that whilst innovation is unequivocally associated with neither large nor small firms, small firms exhibit distinct behavioral advantages in innovation whereas the key advantage of large firms tends to be material.

The conclusion that emerges from the above discussion is that the type of definition the individual researcher choses to utilise depends largely on the nature of the research being carried out.[3] For the purposes of this research, a simplified composite definition will be used that takes into account some of the specificities of small firms in transitional economies whilst taking cognisance of the general characteristics, both qualitative and quantitative, observed above. The following criteria shall be included:

- The firm must have an independent status in the sense of not being controlled by a large enterprise. Thus, it is sought to exclude firms which are linked through full or part-ownership to a large enterprise, since this would invalidate the criteria that small firms must have ultimate management responsibility (Bolton 1971). In the context of transition economies, subsidiaries of multinational enterprises and parts of newly-emerging conglomerate forms of organisations, such as financial-industrial groups in the Russian Federation, are therefore excluded.

- The firm is operating in the private sector of the economy. Most small firms previously under state-ownership have been privatised fairly rapidly (Estrin 1994)

[3] Indeed, under a 'grounded definition' approach as used by Curran and Blackburn (1994) the criteria for selection are determined by the subjects of the study rather than the researchers themselves.

but new ones are emerging in the process of state-owned enterprise (SOE) restructuring prior to privatisation. The emergence of a private sector is a new phenomenon in the transitional economies and new private small firms are qualitatively different from their state-owned counterparts, most of which are still relying on some degree of protection or patronage, either from the state or from large SOEs (Earle et al. 1995, Alfandari et al. 1995). The different problems and dynamics of development in SOEs lead us to exclude them from this enquiry.

- Whilst the study is largely qualitative in nature (see chapter 1), relevant statistics will be utilised in order to demonstrate the dynamics of the evolution of the small firm sector. Hence there is a need to include an 'objective' variable in our definition. In order to allow cross-sectoral and cross-national comparisons, 500 employees will be set as the upper limit for small and medium-sized enterprises.[4]

Although somewhat crude and exhibiting some weaknesses, the definition includes the major criteria used in Russia, Hungary and countries of Western Europe to define small firms and allows for valid generalisations and comparisons to be drawn. The current obsession by many governmental bodies in East/Central Europe with size definitions of small firms can be viewed as a continuation of the 'size cult' of the previous regime, although the pendulum has swung to the opposite extreme.[5] A further elaboration of definitional issues yields few benefits.

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[4] When appropriate, differentiations between micro, small and medium enterprises will be made using national definitions. However, for the purposes of indicative cross-national comparisons, this somewhat crude definition will suffice.

[5] The issue of 'size cult' will be returned to in chapter 4. The debate about definitions of small firms appeared to be particularly fervent in the Russian Federation as witnessed during interviews with some of the top-level policy-makers and further evidenced by the plethora of definitions that emerged since 1991 (see chapter 5). In Hungary also, a number of 'official' definitions are being used which were amended on a number of occasions during this study.

## 2.2. Small firm policy in the context of economic theories

Before considering the rationale of small firmpolicies and their theoretical context, it is perhaps useful useful to define the concept of small firm policy. In a narrow sense, small firm policies can be defined as programmes of support targeting a particular group of firms as defined by size criteria with a view to promoting the growth and efficiency of that sector (OECD 1975, Smallbone and Piasecki 1995, Storey 1994). However, aside from such explicitly defined policies, it has to be recognised that small firm development is influenced by a variety of government policies, the specific aim of which may lie partly or wholly elsewhere. Macroeconomic policies such as fiscal and monetary policies are a good example of policies that greatly impact on the development of small firms due to their sensitivity to interest rate levels and the direct and indirect costs imposed through taxation (Smallbone and Piasecki 1995, Stanworth and Gray 1991, Storey 1994). In order to give greater coherence to the notion of small firm policy, it is useful to draw upon a 1975 report by the OECD on industrial policy, which views industrial policy as constituting "...a focus of attention on a set of objectives related to industrial activity and development" (OECD, 1975, p.8) which is operationalised through more or less efficient co-ordinating mechanisms. Applying this definition to small firms, as a distinct sector in the economy, the multiplicity of policy fields and diversity of policy-making institutions can be accomodated whilst retaining a degree of coherence necessary for description and evaluation in later chapters. Having defined the concept of small firm policy, let us turn to an examination of the rationale for this type of government intervention.

In the context of classical and neo-classical theories, government policy towards the small firm sector is superfluous. J.S. Mill wrote in 1848 in his *Principles of Political Economy*:

> ...of large establishments generally, when compared with small ones, whenever competition is free its results will show whether individual or joint stock agency is best adapted to the particular case, since that which is most efficient and most economical will always, in the end, succeed in underselling the other. (quoted in Bannock, 1981, p.79)

According to the classical economists, the free market has an internal dynamic - the famous "invisible hand" - which ensures that the optimum structure of the enterprise sector is realised in the longer run. This was demonstrated formally in the first fundamental welfare theorem developed by Arrow and Debreu. They proved that in theory perfectly competitive markets in the absence of externalities are not only efficient, but also Pareto optimal, that is, no individual can be made better off without decreasing the welfare of another (Atkinson et al. 1996). In the words of Adam Smith

> ... every individual...neither intends to promote the public interest...he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. (quoted in Sloman, 1991, p.23)

However, the caveat to this model was that social efficiency can be only be achieved in the absence of externalities and under conditions of perfect competition. In the real economic world, of course, externalities (both positive and negative) affecting both production and consumption are entirely common-place (Mishan 1981, Sloman 1991). Moreover, as Stiglitz (1994) forcefully demonstrates, the assumptions under the model of perfect competition are quite unrealistic and so robust conclusions cannot be inferred from the model. The assumptions of perfect knowledge and complete markets are certainly not fulfilled. Information is not only scarce but also costly to obtain, and the price mechanism is of limited ability in the transmission of information (Powell 1990). Situations of inadequate or asymmetric information prevail giving rise to problems of adverse selection and moral hazard (Storey 1994). Markets are also incomplete. Barriers to entry are pervasive and firms are drawn into entry not by the *ex ante* existence of profits but by the anticipated profit opportunities *following* entry, in many cases because

of the possibility of constructing a monopoly position. In short therefore, the real world is full of examples of market imperfections and market failures (Atkinson et al. 1996).

One also has to bear in mind that even given the possibility of Pareto optimal efficiency under certain conditions, it might have to be weighed against social considerations of equality. Socially efficient markets might occur in the context of a highly unequal income distribution. Government intervention might lead to a more even, and thus socially desirable, income distribution, but this action could undermine the extent of Pareto optimality (Atkinson et al. 1996).

Lastly, it has been recognised that in the presence of market failures there is a case for government intervention. However, this leads to the problem of the "second best solution", where the elimination of one distortion generates other distortions elsewhere in the economy (Sloman 1991). Thus, liberal economists would argue that it is not sufficient to demonstrate market failure as a justification for intervention, rather that the costs of the intervention must be lower than the final benefits. In other words, the achievement of a net benefit as a result of the intervention needs to be demonstrated (Storey 1994).

Opponents of government intervention have also highlighted the fact that not only markets fail, but also governments. Governments, it is argued, face similar problems as do markets in respect of information inadequacy and imperfection. In addition, government intervention could conceivably lead to rent-seeking behaviour, where the competition for such rents leads to a waste of resources. However, recent political economy literature on industrial policy shows how costs associated with imperfect information or rent-seeking can be lowered through organisational changes in bureaucracies and political competition (Chang 1996). Moreover, the generation of rent may be one of the main ways to bring about the necessary capital with which to finance industrial development. For example, an important element of South Korean industrial

development experience was to allow private firms to compete for the right to appropriate rents, which they could use to finance the next round of capacity expansion (Amsden 1994).

Lastly, the classical and also the neo-classical models essentially underestimate what Newlands (1995) terms the 'growth function' of government - that is the potential of government to raise the dynamic efficiency of an economy in the long run at the cost of short-term static allocative efficiency (Newland 1995, Chang 1996). Thus, classical and neo-classical theories could be criticised on the grounds of their mainly static perspective on efficiency.

Marxist economists take a different view towards small firm policy. The overall recommendations of it, however, are not entirely dissimilar to neo-classical economists, albeit for different reasons. For Marxist economists, small firms epitomise petty bourgeois enterprise. They express considerable doubt regarding the efficiency and dynamism of small firms (Eisenschitz and Gough 1993, Rainnie 1989).[6] In particular, Marxists question the employment potential of small firms, arguing that much of the competitiveness of small firms is based on sweated labour and poor working conditions. Thus, they would either dismiss small firm policy entirely[7] or advocate a more interventionist approach seeking to control employment aspects (Rainnie 1989).

Other authors take government intervention in the economy as a given, but argue for small firm policies to more fully address the distortionary effects various other forms of government intervention generate. Bannock and Peacock (1989), for example,

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[6] The Greater London Council stated in a report that "Small firms have contributed a minor share of new gross employment." and that the Thatcher government's promotion of small firms was "...a class strategy designed to weaken organised labour in large enterprises and to strengthen a petit bourgeoisie which had been in long term decline." (GLC, 1983, pp.15-16 as quoted in Curran and Blackburn 1994, p.13).

[7] In the UK, radical initiatives such as the West Midlands and Greater London Enterprise Boards in the 1980s tended to exclude small firms (with the exception of workers co-operatives and ethnic minority businesses) from their local economic policies (Eisenschitz and Gough 1993).

demonstrate that compliance costs with VAT regimes affect small firms to a greater extent than large firms, rendering small firms at a competitive disadvantage. In order to improve the competitiveness of small firms, they argue, such 'artificial' costs need to be eliminated through government policies. This argument, however, raises the question as to which costs are 'artificial' and when large firms have legitimate cost advantages due to scale economies.

However, in the majority of real-life cases the rationale for small firm policy is not being questioned. There appears to be an increasing consensus amongst policy-makers at various levels of government on the importance of small firms to both national and local economic development. This consensus extends to include the view that small firms are in some sense disadvantaged. A recent European Commission report states that "While SMEs are potentially a dynamic source of employment growth and wealth creation, it must be recognised that they are inherently weaker and more vulnerable to failure, particularly in the early years." (Commission of the European Communities 1996, p.3). These weaknesses stem in the view of the Commission from five sources, namely access to product and services markets, access to finance, internal structural weaknesses, difficulties in accessing research programmes and the exploitation of these, and the increasing complexities of the legal, fiscal and administrative environment (Commission 1996). Governments have an important role to play in the elimination of these gaps and constraints, thus releasing the full economic potential of the small firm sector. Aside from these 'arguments from principle' (Stanworth and Gray 1991) which are loosely based on concepts of market failure, there are also 'arguments from practice', based on more or less clearly demonstrated externalities that small firm development generates.[8] Storey (1982, 1987 and 1994) argues that since most governments pursue small firm policies for reasons such as job creation in any case, more research should focus on the efficacy of such policies rather than arguing the rationale for it.

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[8] The commonly referered to externalities are in respect of innovative activity, flexibility, competition and employment (Stanworth and Gray 1991).

In the context of transition economies, we have seen a shift from one extremist pole to the other. Starting from a system where the state not only intervened but actively controlled all types of economic activity, governments in transition economies, at least in their rhetoric, rapidly moved to embrace neo-liberalism wholeheartedly (Gowan 1995, Schuler 1998, Myant 1999). In the short-term, governments are committed to restoring equilibrium conditions by removing distortions inherited from central planning (Granville 1995). The ideas of Keynesian demand management or industrial policy-type supply-side policies are being rejected (Knell 1996) and the main focus is on liberalisation, stabilisation and privatisation, with the private sector seen as the engine to future growth (Lavigne 1995, Myant 1999).

However, the need for a small firm policy is pressing in transition economies, probably more so than in the Western market economies. Small firms have an important role to play in the transition period (see chapter 4). Following Storey (1994), this potential in itself can be used as justification for government intervention.[9] In conditions of endemic market failure, the chances of developing a well-functioning small enterprise sector are minimal: there are huge institutional and financial gaps which effectively preclude small enterprises from obtaining the necessary resources with which to become established, to consolidate and to expand. The value of a well-developed and socially-embedded institutional framework is now accepted (North 1990), yet in the drive to dismantle communism and central planning virtually all the old institutions are being dismantled without any effective replacements being established. Knaack (1996) argues that as old institutions vanished, new ones failed to emerge or did not fit the institutional remnants of the old system. Within such an institutional vacuum, he argues,

> ...people are pursuing short-term goals which can be better achieved by redistributive activities than by productive activities... almost everything that can

[9] Chapters 4 and 5 examine this issue in greater detail.

> be easily removed and sold on the market is indeed being removed and sold... double bookkeeping now takes the 'legal' form of establishing 'small enterprises' parallel to existing ones and selling most of the output through the former...this is nothing but the 'mafiazation' of the economy .... (Knaack, 1996, p.269)

Casson (1995), in theorising on entrepreneurship, notes that institution building is essentially a top-down process with the government playing a pivotal role in the design and development of institutions. Rather than assist small enterprises directly, government policy has a major role to facilitate the establishment of institutions which provide the longer run support for small enterprises.

With regard to the need for financial resources, there are also problems which effectively only government can solve. Small enterprises in Central and Eastern Europe essentially remain outside of the "soft money circuit", which arose under Communism to supply large firms with the requisite cash to manage their operations, and which continues today albeit to a lesser extent (Gros and Steinherr 1995,Pawlowska and Mullineux 1998). For a variety of reasons (risk, collaterisation problems) small enterprises are "crowded out" of financial markets. Yet, as Amsden et al. (1994) forcefully argue, it will be impossible to create "capitalism without capital".

Redress of these phenomena cannot be achieved by macroeconomic policies alone, but also requires the development of appropriate institutions at the meso- and microlevels. Janos Kornai, one of the major critics of the old Communist system, has emerged to become one of the main champions of institutions which directly stimulate the development of small and medium enterprises. Kornai (1990) holds that only when state enterprises are embedded in a sea of small-scale enterprises will the time be right to liberalise the state enterprises completely.[10] This is very much the experience of China's economic transformation since the death of Mao in 1978 (Oi 1992). It is also one of the

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[10] This line of thought will be taken up again in chapter 3.

reasons why Goldman (1994) was left to conclude that the Russian reform to date has been a complete failure - because the government failed to implement the policies which would have brought about a major wave of new small enterprises. Therefore, governments should 'grasp the nettle' (Amsden 1995) of intervention and focus on the design of appropriate policies to stimulate small firm development.

A second line of argument for small firm policy during transition can be provided from a competition angle. Although, as was mentioned earlier on, perfect competition as depicted in the Arrow and Debreu model is largely a theoretical construct with little bearing to the real world, competition or contest yield, by and large, positive effects.[11] In centrally planned economies, however, competition was considered "...an inadmissable luxury and waste of resources..." (Antosenkov 1991) and the subsequent high degree of concentration and monopolisation is well documented (Hanson 1994, Newbery and Kattuman 1992, Audretsch 1993). In addition, close relationships between company directors established during the period of planning and subsequent transition are likely to perpetuate non-competitive behaviour (Hanson 1994). And, although privatisation programmes were seeking to promote competition by changes to the previously rigid principal-agent structures (Estrin 1994, Gros and Steinherr 1995), the evidence so far suggests that, rather than promoting changes in enterprise behaviour, privatisation might in practice have led to an entrenchment of the old elites, sometimes leading to opportunities of destructive entrepreneurship (Chance 1999, Kozul-Wright and Rayment 1996). Government policy should, therefore, be aimed at encouraging much greater competition at the micro-level. As Stiglitz forcefully argues,

> ...the first objective of state economic policy is to ensure competition. This needs to be taken into account in the process of privatisation and reorganising state enterprises, *as well as* in the laws allowing the formation of firms, cooperatives

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[11] There are instances when competition can be seen as having negative effects such as when destructive action is taken to raise rival's costs, in cases of rent dissipation and when cooperative behaviour is discouraged (Stiglitz 1994).

> and partnerships.... In the United States and other Western economies, governments have imposed a variety of taxes and regulations that serve as an important impediment to small firms. While these impediments have a significant cost to these more advanced countries, the costs to the former socialist economies - *beginning with virtually no competitive structures* - may be far greater. (Stiglitz, 1994, p.256, italics added)

Following the Japanese approach (see Friedman 1988), competition can be promoted by placing great emphasis on the emergence of new entrepreneurs rather than the privatisation of state-owned firms (see also Kornai 1990). Thus, the need for small firm policies in the transitional economies of Central and Eastern Europe should be viewed not only in the context of neo-classical but also institutional and evolutionary economics (Nooteboom 1992 as quoted in Kondratowicz and Maciejeweski 1994). As Kozul-Wright and Rayment (1996) conclude:

> ...policies to encourage entrepreneurship do not imply removing the state from the economy. Indeed, entrepreneurship highlights the central importance to any transition agenda of missing state institutions in the East...the question of industrial policy needs to be placed on the transition agenda despite the ideological hostility towards it in both the East and the West.... (Kozul-Wright and Rayment, 1996, p.232)

Having argued for a rationale for small firm policies in the context of institutional economics in the transition economies, the following sections pursue a closer study of the 'how' of small firm policies and seek to establish a framework within which small firmpolicy can be analysed.

## 2.3. The framework of small firmpolicies

### Objectives

Objectives of small firm policies differ among European Union countries but four main themes have been highlighted (de Koning et al. 1992 as quoted in Storey 1994). Policy objectives at the national level focus on competition (a competitive market assuming large numbers of buyers and sellers), the strengthening of the production chain (small firm - large firm linkages), diversification (small firms providing a wider range of products and services thus enhancing consumer choice) and employment creation and/or the reduction of unemployment. However, as Storey (1994) notes, objectives are commonly inferred rather then explicitly stated:

> The fact that it is only possible to infer objectives by observing policies in operation, rather than these clearly being stated as a coherent response to an agreed role which government plays within the market-place, is a severe criticism. If the objectives of policy are not specified, then it is impossible to specify policy targets. *If targets are not specified it is impossible to decide whether or not the policies are in some sense 'successful'.* (Storey, 1994, p.258, italics added).

Eisenschitz and Gough (1993) note similar problems in the case of local economic policies where "...policy-makers have been reluctant to clearly define their aims. Where aims are stated at all, they are often anodyne, such as 'regenerating the local economy' or 'tackling unemployment'." (Eisenschitz and Gough, 1993, p.113). Similarly, in a report on industrial policies in European Union countries the OECD observed the elaboration of policy instruments without clearly-defined policy objectives resulting in a lack of strategic focus (OECD 1975).

The key issue here is that the often ambiguous or absent definition of objectives is creating measurement problems, making assessments as to whether government

intervention is actually enhancing welfare difficult (Coulson 1990). Storey goes on to suggest a more useful framework of analysis in terms of intermediate and final objectives.

Table 2.1: Objectives of small firm policy

| Intermediate | Final |
|---|---|
| Increase employment | Increase employment |
| | Reduce unemployment |
| Increase number of start-ups | Increase number of start-ups |
| | Increase stock of firms |
| Promote use of consultants | Promote use of consultants |
| | Faster growth of firms |
| Increase competition | Increase competition |
| | Increase wealth |
| Promote 'efficient' markets | Promote 'efficient' markets |
| | Increase wealth |
| Promote technology diffusion | Promote technology diffusion |
| | Increase wealth |
| Increase wealth | Votes |

Source: Storey, 1994, p.260

Whilst such a typology does not entirely remove the ambiguity surrounding policy objectives, it is a more useful framework inasmuch as it highlights the multitude and frequent overlapping of policy objectives.

## Instruments

As far as instruments of small firm policies are concerned, these can be grouped into a number of distinct areas. Firstly, one of the key types of instruments which governments employ to assist the small firm sector is financial instruments, ranging from direct grants, subsidised loans, loan guarantees to tax concessions and so forth (see Bridge et al. (1998) for a detailed summary). These instruments were developed largely in response to the difficulties small firms faced when raising capital for start-up and growth. However, recent research suggests that developments in financial institutions require a closer look at other forms of financial assistance particularly the development of venture capital (Stanworth and Gray 1991). A second area of assistance is related to advice and training based on the premise that entrepreneurs often do not have ready access to the skills required to run a business. The lack of easily available information to small firms is also often identified as a key constraint to their development (Commission 1996). A third type of instrument is that of deregulation and legal simplification. Bannock and Peacock (1989) illustrate how firms of smaller dimension have a competitive disadvantage vis-à-vis larger firms due to higher unit costs of compliance with government regulations and that therefore governments should seek to reduce such 'artificially' imposed costs (see previous section). Other authors, however, argue, that far from reducing the legislative burden on small firms, governments should seek to more closely monitor and enforce issues such as employment legislation in small firms to prevent 'sweatshop' practices (Rainnie 1989). A fourth group of instruments is associated with macroeconomic policies such as interest rates, taxation and public spending, for instance. Storey (1994) points out that whilst the effects of macroeconomic policies on the survival and growth of small firms differ between countries their impact is not to be underestimated. Lastly, instruments of small firm policy can be seen in the form of assistance with location and premises. Recent years have seen an explosion of science parks and other types of technology transfer centres which are delivering a wide range of policy instruments to resident firms including

access to university infrastructure and research facilities, finance for start-ups, collective support services and the provision of premises (Komninos 1997).

One of the key issues that emerges when looking at small firm policy in the context of instruments and objectives is that a wide variety of instruments is being utilised with often ill-defined objectives. Moreover, in many instances, instruments are ill-suited to match the objectives set. As Wilson (1982) points out in a study on local small firm policies, "Although most local authorities claim that their overriding objective is the maximisation of employment opportunities, *their assistance tends not to be job oriented, but rather problem oriented.*" (Wilson, 1982, p.90).

Thus many of the above highlighted instruments seem to be a reflection of what the *perceived* needs of the small firm sector are rather than a coherent set of instruments developed to pursue defined policy objectives. Eisenschitz and Gough (1993) argue that "...the apparent concreteness of such policies gives them a wide appeal, sidestepping the difficult and politically sensitive issues of whom these policies will benefit." (Eisenschitz and Gough, 1993, p.114). Storey (1994) observes that in the UK "...policies have been introduced on a piecemeal basis, often in response to pressure from small firmlobby organisations and to changes in the macroeconomy." (Storey, 1994, p.257). The lack of a strategic framework for small firm policies may be politically expendient, however, it undermines the effectiveness of policies as the co-ordination of policy fields and institutions is inefficient.

Local versus national level

Another dimension that needs to be considered when analysing small firm policies is the level at which small firm policies are being conducted. The subject of this inquiry will mainly be local/regional level policy, although the framework at the national level will

also be given attention.[12] There are a number of reasons for focusing particularly on the local level. Firstly, there is a wealth of evidence in the literature suggesting that the regional/local economy and the national one require different policy approaches due to local/regional economic specificities (Acs and Audretsch 1993). An increasing body of literature focuses on spatial aspects of small firm development with concepts such as 'industrial districts', 'innovative milieux', 'territorial production systems' and 'regional innovation networks' gaining increasing prominence in the discourse on small enterprise development (Cooke and Morgan 1994, Grabher 1997, Maillat 1999, Pyke and Sengenberger 1992). Secondly, it has been argued that (industrial) policy should be conducted at as local a level as possible since local policy-makers can tailor policies on the basis of highly detailed information to the needs of firms within localities (Geroski 1990). Local authorities are, by definition, closer to the local small firm population and thus information asymmetries are likely to be smaller compared to national-level policy making. As Stiglitz (1994) maintains, information problems are at the heart not only of market failures but also of government failures and attempts should be made to narrow the information gap. Newlands (1995), in the same vein, argues that

> "...decentralised government is likely to be better informed about the preferences of particular individuals or communities and better able to reflect those prefences. Thus, it can be argued that sub-central governments use resources more efficiently than either the market or central government in undertaking expenditure at the local level. (Newlands, 1995, p.72)

Furthermore, the costs of policy intervention at the local level are likely to be smaller compared to the national level since it requires less bureaucratic structures to develop, implement and monitor policies (Newlands 1995). Since at a more complex (i.e. national) level more parties are likely to be involved in the decision-making process this

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[12] In Russia and Hungary, national-level policies provide the general framework for SME support whilst delegating most of the implementation to the local/regional level. Hence, we cannot consider one in isolation from the other. Furthermore, as pointed out above, macro-level policies also impact on the dynamics of small firm development.

might give rise to conflict which is time-consuming and costly to resolve. A third issue is that many small firms are perceived to operate in the local market and hence local governments are likely to seek to promote small firm development as part of local economic development strategies (Eisenschitz and Gough 1993, Curran and Blackburn 1994, Coulson 1990, Syrett 1995). However, it has to be recognised that both in theoretical and practical terms, the role of local government in economic policy is constrained. Thus, stabilisation and distribution policies, which impinge on the dynamics of small firm development, are either not feasible (stabilisation) or suboptimal (distribution) at the local level (Newlands 1995). Again, the need for a coherent strategic framework, taking into account an appropriate balance between the national and the local level, is a key lesson that arises from these observations.

Quantitative versus qualitative strategies

A last dimension that needs to be taken into account when considering the mechanics of small firm policies is the target group of beneficiaries. A number of approaches can be discerned. Firstly, available government resources can be made available to *all* small firms, which necessarily requires an element of spreading resources thinly over a large target group. This approach might also be termed the 'quantity approach' in the sense that no discrimination in favour of particular types of small firms occurs and that the emphasis lies rather on the targeting of as large a quantity of small firms as possible (Bateman 1993). Following this approach, almost any small firm is eligible for support (Bridge et al. 1998).

A second approach might be termed the 'quality approach' which entails the targeting of particular types of small firms (technology-based small firms or high growth firms for instance). Within this approach, policy-makers would be seeking to concentrate resources on a limited number of specifically defined firms, seeking to eliminate

'deadweight' and 'displacement' problems associated with quantity approaches (Bridge et al. 1998, Coulson 1990, Storey 1994).

The third approach differs from the two described above in so far as support is not directed at individual[13] firms but at groups of firms or networks. Government here would essentially act as a network broker, enabling and facilitating the development of linkages or networks between firms, rather than the development of small firms *per se* (Morgan 1999).

The above outlined dimensions (instruments, objectives, levels and target groups) constitute the basis of a framework for small firm policies and have to be analysed in conjunction with one another. So far, a broad overview of the dimensions has been given without providing specific examples and without analysing in closer detail the merits and demerits of policies. Such an analysis is only possible in the framework of national, regional and local specificities which determine the dynamics of small firm sector development within certain localities. The following chapter will draw on case study examples from Western Europe to highlight such locational specificities and to examine in greater depth the success of policies within such contexts. In combining the theroretical and conceptual approaches outlined in this chapter with empirical analysis in the following, the issue as to what what constitutes 'best practice' in small firm policy in Western Europe will be examined.

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[13] In whichever way they are defined and thus are in- or excluded.

# Chapter 3: Models for small firm sector development

## 3.1. Introduction: selection of models

One of the key questions that this research seeks to address is the extent to which 'best practice' policies from developed market-type economies are being transferred to Eastern Europe. The previous chapter has sought to provide a theoretical underpinning to the policy debate as well as outlining a conceptual framework for the analysis of policies. However, the question as to what constitutes 'best practice' and, indeed, if there is an ideal model of good practice in SME development policy, needs to be addressed in greater depth.

This chapter will analyse the policy experience in three locations in Western Europe - in Mondragon in the Basque country of Spain, in the Emilia Romagna region of Italy and, lastly, in the West Midlands region of the United Kingdom. The selection of these three examples of Western practice was based on a number of considerations. Firstly, the policy experience in the three regions contrasts significantly in terms of their overall approach to policy. Furthermore, the context within which policy has been developed, that is the local economic environment and the dynamics of small business development within the locality, differs substantially between the three regions. The inclusion of a range of very contrasting local experiences will enable an analysis of the context-specificity of Western experience, and therefore an assessment of the *transferability* of the policy experience. Following Brusco (1982), Storey and Johnson (1987) and Co-operatives Research Unit (1982) the analysis in the following sections sets policy within the context of 'models' of small firm development, that is a range of stylised factors that have shaped small firm development in the locality.

The second consideration in selecting these three policy experiences was their potential appeal as models to be transferred to Eastern Europe. The Emilian experience is widely

held to be a very successful blueprint for small enterprise development (Brusco 1982 and 1999, Schmitz and Musyck 1994, Trigilia 1992, Pyke et al 1990, Bateman 1999). Mondragon also is considered to a very successful example of small enterprise development, especially of those of co-operative format (Co-operatives Research Unit 1982, Bradley and Gelb 1982 and 1987, Thomas and Logan 1982). The legacy of reforms in the 1980s in Russia and Hungary, which have sought to promote co-operative small enterprises, as well as the privatisation programmes in the 1990s that transferred ownership to workers and managers, might make a co-operative model of small business development appealing to Eastern European policy-makers. Lastly, the West Midlands experience might be viewed as worthy of emulation by East European policy-makers, as the strongly neo-liberal groundedness of policies pursued in the West Midlands fits well into the neo-liberal transitional policy agenda (Lavigne 1999, Schuler 1998, Gowan 1995).

A third consideration that influenced the selection of these three West European models has been the nature of donor activity in Eastern Europe. Much of the financial assistance from multilateral and bilateral donors has been accompanied by policy advice based on experiences in the donor nations. Thus, European Union countries, as a main group of donors in Eastern Europe, might well seek to transfer their own experiences and practices in terms of small firm policies to the East.

Lastly, these three West European cases are all characterised, albeit to varying degrees, by forms of economic reconstruction. In the Emilian and Mondragon case, early small firm policies were developed in the context of post-war reconstruction. The West Midlands region also has seen significant reconstruction, although here it took place in the context of de-industrialisation. In Eastern Europe, the evolution of small firms and the development of small firm policies takes place in the context of systemic transformation, an extreme form of economic reconstruction.

The following sections will describe these three models of small firm development in Western Europe by outlining their key features and characteristics. In doing so, the question as to what constitutes 'best practice' in policy-making will be addressed. Furthermore, in analysing the policies and policy contexts in the three models, the possibilities for and constraints on the transferability of the Western experience will be examined.

## 3.2. The Mondragon model of co-operative development

The Mondragon model is an example of small firm sector development which combines the virtues of small firm development with those of the co-operative movement. The first co-operative, Ulgor, was founded in 1956 by five pioneers under the spiritual guidance of Father Arizmendiarrieta, a Catholic priest whose thoughts and ideas greatly shaped the emergence of Mondragon (Azurmendi 1984, Oakeshott 1972). Mondragon has, despite the unfavourable political climate under the Franco regime and the worldwide recessions in the 1970s and 1990s, since grown not only in size but also in scope. In 1996, the *Mondragon Corporacion Cooperativa* (henceforth Mondragon or Mondragon complex) employed 30,634 workers in over 100 enterprises (Mondragon Corporacion Cooperativa 1996). These figures suggest that the Mondragon complex has been a stunning success in providing a framework within which the majority of its original small co-operatives have been able to very successfully cross the threshold to becoming large enterprises. The question arises as to what the factors are that contributed to such extraordinary growth in only thirty years - from a single co-operative with five members, to a co-operative complex constituting the largest employer in the region. Part of the explanation lies in the fact that Mondragon has pursued a policy of promoting limited new entry of small firms on the one hand, whilst seeking to limit employment in existing co-operatives through the active promotion of spin-offs, on the other. In an empirical investigation into the growth and performance of Mondragon firms, Thomas and Logan (1982), remark on the size structure of firms:

As for the size of the enterprises, evidence suggests that the co-operatives aim at operating on the horizontal part of their long-run average cost curve, stretching from about 50 to 250 places. CLP (Caja Laboral Popular) assistance makes it possible for small co-operatives to overcome barriers to entry: the co-operatives themselves aim at size limitation, since there is a consensus that large size jeopardises meaningful participation. (Thomas and Logan, 1982, p.128)

The decision to limit the size of the co-operatives can be traced to the only strike that took place in the Ulgor co-operative in 1974, with the issue at stake being job revaluations. The subsequent investigation concluded that:

> One of the factors identified as being partly responsible for events getting out of control was the sheer size of Ulgor, which then had a membership of 3250, causing inadequate communication and leading to worker alienation. Since that time, the general policy is to keep unit sizes as small as possible. (Thomas and Logan, 1982, p.35)

Thus, the co-operatives are seeking to maintain the advantages associated with smaller scale units through active intervention. More importantly, a unique institutional setting has evolved that has enabled the co-operatives to overcome some of the disadvantages associated with small scale.

One of the key problems associated with small scale enterprises has been their inability to access finance. Already in 1931, the Macmillan Committee in the UK identified a finance gap for small firms (known as the "Macmillan" gap) and later investigations supported these findings (see for instance Bolton 1971, Stanworth and Gray 1991). Storey (1994) points to problems of adverse selection and moral hazard as a result of asymmetric information causing market failure in loans markets for small businesses. In the case of co-operative enterprises, the problems in accessing finance are compounded in some cases by legal restrictions and their often observed unwillingness to accept

outside funding for fear of jeopardising independence (Thomas and Logan 1982). Yet, as Vanek (1975) demonstrates, the self-financing of co-operatives could lead to some internal inefficiencies, and concludes that self-managed enterprises should therefore rely on a mixture of internally generated funds and outside finance. On a theoretical level therefore, loan finance is the most desirable form of finance for co-operatives but the markets for loan funds are likely to be highly imperfect.

The Mondragon complex has sought to overcome this dilemma through the creation of a second-tier[1] credit co-operative, the Caja Laboral Popular (CLP), which was set up in 1959. The CLP has been instrumental in shaping the co-operative complex in a number of ways. Firstly, it acted on behalf of the co-operative firms in the mobilisation of local savings (Campbell et al. 1977). The continuously successful fulfilment of this function ensured the elimination of financial constraints on the setting up, expansion and growth of the co-operative enterprises within the complex and hence the extraordinary growth exhibited by the Mondragon complex.[2] At times, the rapid growth in deposit accounts has resulted in CLP having to actively encourage investments by the industrial co-operatives in order to strike a delicate balance between aggregate co-operative sales and financial resources as well as meeting self-imposed margins (for a detailed analysis on financial planning by CLP see Thomas and Logan 1982). Secondly, the Empresarial Division has acted as the entrepreneurial arm of the complex and in this function has been responsible for the fleshing-out of entrepreneurial policies. Proposed new ventures are being screened as regards their viability and upon approval supported financially and otherwise (see below) by the bank and other institutions within the complex. The approach of the bank regarding the entry of new co-operatives is largely a market-oriented one focusing on the identification of unsaturated or new product markets and

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[1] Spanish Law allowed for the setting up of so-called 'second-degree' co-operatives which are associations that were not directly worker-owned and controlled but owned and controlled by other co-operatives ( for a fuller description see Arizmendiarrieta 1984)

[2] Only very recently have there been proposals to finance new ventures and increase investment in existing ones by means of a financial holding company with domestic and foreign institutional funding (Burns 1994).

upon the potential for what has been termed "collective efficiency" (Schmitz 1992, Schmitz and Musyck 1994) benefits within the group. Thus, the promotion of new ventures has centred primarily on industry (primarily household consumer durables, house construction, machine tools and capital goods), agriculture, housing, education and research.[3] Self-financing targets, employment generation and returns on capital investment, as determined by the CLP, are another consideration when screening new ventures. The screening process is a sophisticated and detailed one focusing on the quality of new ventures[4] rather than on job creation through mass entry. The success of it can be seen in the steady employment and wealth increase within the group (Foote-Whyte and Foote-Whyte 1988, MCC 1996) and in the near absence of failed ventures (Thomas and Logan 1982).[5] In addition to selecting and financing new start-ups, the CLP is also providing existing co-operatives with managerial advice, often taking advantage of outside experts and consultants. This is a type of real service which individual co-operatives would find difficult to afford. A final feature of CLP that is worth closer attention is the continuous commitment to interaction with the Basque community through the promotion of institutions aimed at the welfare development of the local community. A passage in a CLP Annual Report highlights the concern with wider social issues concerning local communities and the essentially humanitarian concerns of the co-operatives:

> CLP stands irrevocably for respect for human liberty, to which end it will dedicate all its economic and human resources through enterprise reform, to ensure democracy and freedom: through education for all without discrimination; through information to strengthen community consciousness; through health, so that its policies can be pursued in a socially optimal fashion; and through authority, so that

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[3] Over the last few years we have in addition seen an expansion of co-operatives in the distribution group (MCC 1995 and 1996).

[4] This highly selective approach has resulted in the start-up of limited numbers of ventures per year only, sometimes as few as one or two only (Ellermann 1985).

[5] Throughout Mondragon's history, only one co-operative has folded, a fishing co-operative. Subsequent studies by the CLP highlight the lack of co-operative culture among fisherman as one of the key factors responsible for the lack of success and the subsequent disbandment of the venture.

> the CLP can be an instrument used by society in its democratic organisation. (CLP 1975 as quoted in Thomas and Logan, 1982, p.91)

Thus, the CLP should be viewed not only as an economic institutions but part of a social network within the Basque provinces (see Birley 1985, Szarka 1990 and Powell 1990 on network analysis).

The development of CLP sparked a wave of births of second-degree co-operatives aiming to overcome bottlenecks associated with size and/or co-operative status. These include a social security co-operative[6], a university-level technical school, a business school and a factory school focusing on the training of apprentices.[7] In response to a lack of technological know-how of enterprises within the group and the economic crisis in the mid-1970s[8], a research co-operative, Ikerlan, was set up in 1977. Ikerlan focuses largely on the provision of the latest technological know-how to the co-operatives, the diffusion of new technologies within the group and the dissemination of technologies developed within the group including sale to third parties (Thomas and Logan 1982). Thus, even small co-operatives in the group are able to obtain latest technological know-how at an affordable cost, enabling them to overcome material constraints associated with their small scale. Two further research co-operatives, Ideko and Maier Technology Centre, were set up following the success of Ikerlan, with a largely sectoral focus on machine tools and thermoplastics respectively (MCC 1996).

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[6] Under Spanish Law, co-operators were classed as self-employed and as such did not qualify for state-funded social security benefits. The Mondragon co-operatives responded by developing their own social security system which was initially run by CLP and later spun-off into a separate co-operative - Lagun Aro.

[7] A separate institution, the League of Education and Culture, was set up to facilitate links with the coops and the educational system on the one hand and the wider community on the other. The Mondragon coops have through the League played a significant role in the promotion of Basque culture and in particular language which was not taught in mainstream schools at the time (see Johnson and Foote-Whyte and Foote-Whyte and Foote-Whyte 1988).

[8] The Mondragon co-operatives had previously relied on the purchase or in some instance copying of patents and licences domestically and from abroad for new product development. With the acceleration of technological development and the deepening economic crisis in the 1970s, the limitations of such an approach to technological development were becoming apparent.

Following Szarka (1990), different types of network structures can be observed in the Mondragon group. Firstly, exchange networks exist between enterprises along sectoral lines. The first of these groups, Ularco, was set up in 1964, in recognition of the need to attain economies of scale in order to remain competitive on an international basis whilst not sacrificing the advantages of close worker involvement (Thomas and Logan 1982). A number of such generic industrial groups have since emerged exploiting synergies and scale economies (MCC 1996) as well as being able to weather economic recessions by transferring resources between co-operatives (Benton 1992). The second type of network structure, information networks, is evident in the interaction with the second-degree co-operatives described above. These structures have served important support functions that enabled the co-operatives to overcome some of the practical obstacles to development associated with their size and co-operative status. The final type of network structures, social networks, are evidenced by the strong embeddedness of the co-operatives in the local communities. On the one hand, the Mondragon co-operatives have sought to rejuvenate local communities not only through job creation but also through the provision of welfare services (Foote-Whyte and Foote-Whyte 1988, Arizmendiarrieta 1984, Azurmendi 1984). On the other hand, the local communities have played a pivotal role in supporting the co-operatives. The first co-operative, Ulgor, was funded through loan and equity capital raised by the local community (Thomas and Logan 1982). Later, local people invested their savings in the CLP not only because of financial returns but also out of a sense of communal responsibility (Campbell et al. 1977, Thomas and Logan 1982). The symbiotic relationship between the co-operatives and local communities is a key strength of the Mondragon co-operative system.

The above description of the network structures provides an insight into the unique organisation of the Mondragon co-operative complex. The type and nature of the linkages is best encapsulated in the notion of 'institutional thickness' (Amin and Thrift 1995) referring to the embeddedness of firms and institutions (Grabher 1992) in a spatially-defined community. It is this embeddedness that has enabled the Mondragon

group to continuously reinvent itself in the light of changing global markets (for a discussion on the global/local interface see Amin and Thrift 1995 and Huggins 1997) and of economic cycles, and to meet the challenge of new competition. However, the 'specialness' of the Mondragon experience is not confined solely to organisational features and other pieces need to be considered when assembling the Mondragon puzzle.

Any discussion of the Mondragon experience would be incomplete without reference to co-operative forms of ownership. The literature on the labour-management is extensive (see for example Ward 1958, Vanek 1970, Horvat 1972). Vanek (1970) shows that a labour-managed economy can theoretically attain Pareto-efficiency. If certain conditions are absent, however, labour-managed economies will also depart from the optimum as much as the equivalent capitalist-managed economy. The key requirement for attainment of long-run equilibrium in the labour-managed economy is free and easy entry (Vanek 1970). Vanek concludes that "... the labor-managed economy is not only highly efficient in absolute terms, but also more efficient than other existing economic systems. This holds from the point of view of both allocational and distributional efficiency." (Vanek, 1970, p.403).

However, the above analysis has been criticised on the grounds of falling into the same traps as neo-classical microeconomics as regards the validity and robustness of basic assumptions (Stiglitz 1994). Bergson (1967) is also less than optimistic about the performance of the labour-managed variant of the economy. The evidence regarding the performance of labour-managed firms in capitalist economies is similarly contested. According to some views

> ...they (worker co-operatives, added) have a reputation, strongly influenced by the writings of the Webbs, of collective egoism, and are assumed to have little long-run potential for economic survival in a hostile capitalist environment. Producer co-operatives supposedly are bound to degenerate into forms of capitalist control,

and tend to be less efficient than capitalist enterprises. (Thomas and Logan, 1982, p.3)

Despite these very pessimistic predictions, however, there is increasing evidence in the literature of the viability of worker-managed enterprises in capitalist economies (Garson 1973, Bellas 1975, Hadley 1971, Bartlett and Pridham 1991). Mondragon can be viewed as an example of not only the viability of worker-managed firms in a capitalist economy but also of their superior economic performance in comparison with conventional capitalist firms in the region (Thomas and Logan 1982). Thus, whilst Mondragon is clearly a 'special' case of worker self-management in the sense of the organisational and institutional structures described above, it nevertheless supports the case for worker-managed firms as a viable and in cases superior alternative to conventional capitalist firms.

The success of the Mondragon model has to be explained not only in terms of the nature of the intra- and inter-firm linkages that have evolved but also in the context of self-management as a prime motivator for co-operative performance (on the issue of worker-utility see Burkitt and Bateman 1990). The direct link between performance of the co-operative members and income distribution acts as an incentive to align individuals' priorities with those of the firm (Foote-Whyte and Foote-Whyte 1988, Bradley and Gelb 1982 and 1987) thus leading to improved economic performance as well as greater humanisation of work (Blumberg 1968).

In unravelling the complexities of the Mondragon system, one has to take account of the view that Mondragon is shaped by a unique set of cultural factors. One such determining factor is the influence of the Catholic Church on the organisation and policies of the Mondragon group (Oakeshott 1972). Skalicky (1975) traces the ideas prevalent in the Catholic Church concerning humanisation of work and concludes that these can be realised only in a society characterised by the realisation of worker

participation. Many of these arguments have been found to be shaping the Mondragon group, too. The Mondragon group's foundation was greatly influenced by the vision of a Catholic priest, Father Arizmendiarietta, and the subsequent developments of the group were as much dictated by the social goals of Arizmendiarrietta as by economic necessities (Foote-Whyte and Foote-Whyte 1988). Arizmendiarrietta continuously stressed the importance of the combination of social obligation and justice, of democratic processes and the need for working with and enabling the development of young people (Arizmendiarietta 1984, Oakeshott 1972). These ideas were translated into policy and institutional design.

A second, related dimension is the notion of 'Basqueness' as one of the driving forces behind the development of the co-operatives (Foote-Whyte and Foote-Whyte 1988). During this century, the Basques suffered under the Franco dictatorship which, in the view of some observers, enhanced already existing social networks and trust relationships (Spear 1982) and reinforced a strong sense of national identity, solidarity and social justice. The combination of these factors made for an ideal breeding ground for the co-operative movement (Foote-Whyte and Foote-Whyte 1988), yet makes Mondragon in the view of some researchers a unique case of co-operative development (Co-operative Research Unit 1982, Eisenschitz and Gough 1993). However, more recent studies have shown that as much as a quarter of the co-operators are from outside the Basque region (Greenwood et al. as quoted in Benton 1992) and conclude that the notion and influence of 'Basqueness' is not unambiguously established and possibly exaggerated. Rather, Mondragon evidences particular forms of trust relationships that have been observed elsewhere (for example in the 'Third Italy') (Brusco 1999) and are thus not unique to the Mondragon case. Furthermore, Sabel (1992) advances a strong case for what he calls 'studied trust', the building of co-operative relationships in mistrustful environments.

When considering the potential for replication of the Mondragon experience, the wider macroeconomic context has to be considered. Some authors maintain that the highly protected Spanish economy, prior to entry into the European Community, facilitated the rapid growth of the Mondragon co-operatives (see Co-operative Research Unit 1982). Indeed, as Thomas and Logan (1982) show, the Mondragon co-operatives initially relied on the copying of patents for technology development, a process facilitated by the closed nature of the Spanish economy and the absence of recognition of international agreements. The international experience in technology development, however, suggests that a policy which relies on 'off the shelf' technology is unsustainable in the longer-term. The co-operatives in the Mondragon complex realised this and new technology strategies were implemented focusing more on technology diffusion and home-spun technology (see the above section on research institutions).

The argument regarding the importance of the closed economy can also be countered by looking at the evidence from comparative studies. Thomas and Logan (1982) in their study argue that the Basque co-operatives outperformed other enterprises in the region which had also benefited from the same degree of protectionism. Spear (1982) maintains that during the period of high protectionism, the Mondragon co-operatives thrived whilst other nearby regions were performing sluggishly, as was the Spanish economy as a whole. Thus, whilst there is some evidence for arguing that trade protection helped the co-operatives to get 'off the ground', the long-term performance and success of Mondragon has not been shown to be directly linked to macroeconomic factors.

Thus, in conclusion, Mondragon can be viewed as a special case of small firm sector development. This 'specialness' arises from the supporting institutional setting and organisational features of the Mondragon complex as well as selective policy intervention. These are the features that have allowed the Mondragon firms to overcome constraints associated with size and co-operative ownership status and enabled them to

compete successfully domestically and internationally in technology- and capital-intensive branches. Nonetheless, whilst this kind institutional 'thickness' is special to Mondragon (since it has evolved in direct response to the needs of the Mondragon co-operatives), it is not unique as such 'thickness' has also been observed elsewhere (Amin and Thrift 1995).[9] A second factor, worker-ownership, also makes Mondragon a special case for small firm development albeit not a unique one. As was shown, the evidence in support of arguments of the 'uniqueness' of Mondragon centres largely on cultural and macroeconomic factors and is not unambiguous. However, a feature that might restrict the possibility of transferring the Mondragon policy experience to other regions is that policies and institutions developed in Mondragon originated within the group of co-operative firms and not from a public sector organisation. This has enabled information assymetries between, for example, the bank and industrial firms to be lowered, thus limiting the potential for adverse selection and moral hazard. The policies are very specific to the institutional set-up in Mondragon and might therefore be of limited relevance to public sector bodies elesewhere. In this context the next section will consider the Emilian experience.

### 3.3. The Emilian industrial district model

Small firm sector development in Italy is characterised by a diversity of trajectories (Storey and Johnson 1987a, Brusco 1982 and 1990). The Emilian model has, however, attracted most attention in the literature. The region of Emilia Romagna has distinguished itself by an outstanding economic performance in terms of unemployment (in 1991 unemployment was just 3.8 percent compared to 10.8 percent for Italy as a whole - Cooke and Morgan 1995) and per capita income and growth (Brusco 1982, Garmise and Grote 1990, Leonardi and Nanetti 1990). As Cooke and Morgan (1995) point out, this performance is especially intriguing in the light of the branch structure of

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[9] The existence of institutional 'thickness', however, does not make a *prima facie* case for success as we will show later on.

Emilia Romagna with its predominance of 'mature industries' that have experienced decline in other parts of the European Union. Furthermore, Emilia Romagna is not only viewed as a prime example of industrial development but also as a model blending economic with social development, involving the transformation from a primarily agricultural into an industrial society (Trigilia 1992). Therefore, it appears to be a particularly appealing model for underdeveloped or developing regions to replicate (Schmitz and Musyck 1994).

The Emilian model has been well documented in the literature as a more sophisticated version of the traditional Marshallian industrial district[10] comprising locally concentrated clusters of small firms or networks that are utilising and benefiting from external economies (Becattini 1990, Brusco 1982 and 1990, Sforzi 1990). Central to the 'industrial district' theme is the flexible specialisation thesis. In their seminal work *The Second Industrial Divide*, Piore and Sabel (1984) argue that the dominant paradigm of Fordism is increasingly under challenge as large oligopolistic hierarchies saturate markets with standardised, mass-produced goods and are unable to meet increasingly the sophisticated demands of consumers for small-batch, custom-made products. The response to these new challenges of competition is the use of flexible specialisation strategies, based on the use of multi-purpose tools by skilled workers, permanent innovation and the reliance on flexible technologies. The flexible specialisation paradigm also includes changes in organisational structures and labour practices as well as policies that encourage the formation of communities of firms and people based on cooperation, rather than competition as depicted in neo-classical theory. Piore and Sabel (1984) consider these developments as the possible constituents of a new, and

[10] The term 'industrial district' was first coined by the English economist Alfred Marshall based on observations of localised clusters of firms in single branches of industry such as the Sheffield cutlery industry (see Marshall 1919). Marshall's ideas were revived by the neo-Marshallians (Becattini 1990, Brusco 1982 for instance) in seeking to explain the dynamics of development in the 'Third Italy'. The subsequent literature is voluminous (Becattini 1989 and 1990, Brusco 1982 and 1990, Sforzi 1990, Trigilia 1992, Pyke 1992, Goodman et al 1989 on Italy; Schmitz (1992), Cooke and Morgan 1995, Grabher 1992 and 1997, Sabel et al. 1989 on Germany; Hirst and Zeitlin 1989, Zeitlin 1989, Simmie 1997 on the UK experience for example).

alternative, industrial paradigm that combines the virtues of small-scale production (replaced in the 'first' industrial divide by mass production) with technological innovation.

These original formulations have been criticised on a number of grounds. Eisenschitz and Gough (1993) argue that far from being outmoded "...there continue to be powerful dynamics towards standardisation and mass markets." (Eisenschitz and Gough, 1993, p.134). The authors base their conclusion on observations regarding the spread of 'new' industries such as electronics and the rise of service-based sectors such as car repairing or retailing which are standardised and reliant upon mass markets. These arguments concur with views that the flexible specialisation theory ignores the growing globalisation of the world economy (Simmie 1997, Amin and Thrift 1995). Another critique challenges the view that flexible specialisation leads to an increasing organisational autonomy. In contrast, some authors argue, a deepening and widening of oligopolistic behaviour and control in thw orld economy can be seen (Amin and Robins 1991 as quoted in Simmie 1997, Hardy and Rainnie 1996). Network theory reminds us of the increasingly blurred nature of boundaries between firms (Powell 1990), with dependency relations actually and potentially persisting (Szarka 1990). A last point of contention with the flexible specialisation theory is the scarcity of examples of true craft-based communities that have been documented (Simmie 1997). Moreover, the emergent new industries which are found in spatially-confined settings such as electronics are not craft-based (Dosi et al. 1988 as quoted in Simmie 1997).

Yet much of this scepticism is based either on a very narrow interpretation or on overambituous claims that the emergence of flexible specialisation based on small firms is the new leading industrial paradigm. As Benton (1992) has argued:

> A close reading of the literature on flexible specialisation shows that the process through which flexible production systems evolve is necessarily open-ended.

> Dynamic growth and novel forms of industrial organisation emerge in some places in the wake of industrial restructuring, while elsewhere similar economic pressures have perpetuated the dominance of large firms or recreated a reliance in small firms on cheaper, unprotected labour in systems of subordinate subcontracting. A range of outcomes appears possible even in superficially similar settings. (Benton, 1992, p. 49)

Thus, the claim made by Eisenschitz and Gough (1993) that not all regions can follow the optimistic Emilian scenario is not disputed in the flexible specialisation discourse. Furthermore, both Fordism and post-Fordism are rarely observed in their 'pure' forms (Tödtling 1995) and the juxtaposition of both can lead to a wide variety of potential outcomes. Therefore, the argument that few districts characterised by flexible specialisation have been documented relates as much to the heterogeneity of districts and the lack of any 'pure' forms. The following section will consider the Emilian case in both its difference from and similarity to other industrial districts.

Emilia Romagna is characterised primarily by a community of small firms.[11] In 1988, 94 percent of all firms in Emilia Romagna were microenterprises (Cooke and Morgan 1995). The SMEs are linked through extensive subcontracting relationships, with some firms acting as 'stage' firms and others as 'final' firms, bringing the finished product on to the markets. The districts specialise along sectoral and branch lines, with for instance tiles located in Sassuolo and knitwear in the Carpi district (Pyke 1992). A spatial division of production within each individual production cycle enables independent small firms to attain external economies that could not be achieved by an individual small firm (Piore and Sabel 1984, Conti 1988, Pyke 1992). The networks of firms are characterised by a high degree of cooperation and competition:

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[11] This is not the case in all of the industrial districts observed. Baden-Württemberg, for example, is dominated to a great extent by large firms, surrounded by clusters of *Mittelstand* firms (Cooke and Morgan 1995, Schmitz 1992). However, the nature of the linkages between firms is not dissimilar to the Emilian case (Schmitz 1992).

The system of production which interacts as a unitary force in the market, is derived from the system of co-operative relations of units specialised according to their different phases in a single production cycle; there are undoubtedly conflictual relations inside the MID *(Marshall Industrial District)* between various units operating at the same stage of production, but nevertheless we can assume that the overriding characteristic of the MID is the network of co-operative relations between units. (Bianchi and Gualtieri , 1990, p. 86, italics added)

Thus, in addition to efficiency gains made from competition, small firms are benefiting from "collective efficiency". This attainment of 'bigness' through organisational and institutional features is seen by many observers to be the key to the explanation of the exemplary economic performance of small firms in the industrial districts (Lazerson 1988, Pyke 1992, Conti 1988). According to Pyke and Sengenberger:

> Small firms, acting on their own, are in a poor position to compete. They lack the resources and the economies of scale and scope normally available to large companies; and they lack the political voice necessary for influencing their economic and political environment... Particular areas of economic activities apart, they need to link up with resource pools of others, be it large firms or small firms, to gain strategic options. Thus, links and networks are paramount to small firm success. (Pyke and Sengenberger, 1992, p.11)

These organisational and institutional features can best be explained using the Marshallian notion of 'industrial atmosphere' or what Amin and Thrift (1995) call 'institutional thickness'.[12] These concepts point to the identity of generic groups of small firms as resting on something beyond productive aspects, e.g. on a common historical-cultural-territorial legacy. In the Emilian model, the latter includes a history of family-based agricultural sharecropping and proto-industrial development, often based around homeworking (Brusco 1982, Trigilia 1992, Bianchi and Gualtieri 1990, Cooke and Morgan 1995). Furthermore, the influence of political and ideological subcultures related to the Catholic Church and local Communist governments in the emergence of

[12] See also Mondragon section.

the districts[13] has been well-documented (Brusco 1982, Trigilia 1986 and 1992). There is strong evidence in the literature that the organisational setting of small firm networks in Emilia Romagna is greatly enhanced by what Pyke terms "homogeneous value systems" (Pyke 1992) or what Putman et al. describe as being "social capital" (Putman et al. 1993). There is, however, no consensus in the literature about whether these common value systems and trust relationships are the cause or the consequence of economic and social development in the industrial districts (Becattini 1990, Sabel 1992, Putman et al. 1993). Nevertheless, common value systems and a closely-knit community appear to be an essential ingredient in the model.

A key role in the emergence of the industrial districts is played by local governments in Emilia Romagna and the policies that have been pursued. The local governments have been instrumental in shaping the institutional networks surrounding the small firm districts (Howard 1990). Intervention can be traced back to the 1950s, with the development of 'associated artisan villages' through land purchasing and planning policy (Perulli 1990). Later, policies focused on the establishment of a system of decentralised business service centres, at the heart of which is ERVET (*Ente Regionale per la Valorizzazione Economica del Territorio*), the regional development agency. ERVET delivers its services through a network of business service centres organised along sectoral (for example CITER - *Centro Informazione Tessile Emilia-Romagna* - in the Carpi knitwear district) and functional lines (such as SVEX, the service centre for export development) (Cooke and Morgan 1995).

These service centres are public-private sector partnership and are engaged in the provision of what Brusco (1992) terms 'real services'. They include technology transfer and diffusion, provision of information and training, testing facilities and the organisation of trade fairs. Individual small firms would find such services uneconomic

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[13] Perulli (1990) provides examples of 'red' regions such as Emilia and Tuscany and 'white' regions such as Veneto and Marche.

to purchase, yet the lack of information puts small firms at a competitive disadvantage vis-à-vis large firms that have the resource to provide these services either in-house (for example R&D) or purchase them from outside as in the case of consultancy. Brusco (1992) argues that there is evidence of market imperfections in the case of real service provision for small firms and that therefore governments, in this case local governments, should intervene to correct such failures. Real services are in some instances complemented by the provision of financial services. Many of these are delivered through credit co-operatives and loan consortia in which both entrepreneurial associations and local governments have stakes. A noteworthy feature of the loan consortia is their dual role. Firstly, they act as a guarantor for loans that small firms obtain from banks and secondly, they negotiate interest rates with the banks (Brusco and Righi 1989).[14] In this function again local governments are correcting market failures, in this instance failures of loan markets to provide small firms with adequate financial resources and competitive prices. However, as a European Commission report (Commission 1992 as quoted in Cooke and Morgan 1995) noted, financial constraints are still evident amongst the Emilian small firms as a result of not only supply-side problems (in particular the provision of venture capital) but also on the demand side with many small firms reluctant or even hostile to offering share capital to outside investors. These problems are currently being addressed, with ERVET becoming more active in the intermediation between domestic and international capital and the small firms in the region (Cooke and Morgan 1995).

In addition to the provision of real services, local governments have fulfilled an important lobbying function on behalf of the small firms in the districts, negotiating on their behalf with local banks in questions of credit, and mediating between local unions and entrepreneurs (Trigilia 1986).[15] However, as Trigilia (1986) and Cooke and Morgan

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[14] Brusco and Righi (1989) note that as a rule, the interest rate granted by the bank in negotiating with the loan consortia is 1.5 percent lower than the going rate for similar kinds of transactions.

[15] Trigilia (1986) stresses that the mediating function should not be viewed as a form of 'local corporatism' since local governments do not directly intervene in negotiations and function more along the lines of traditional pressure group politics.

(1995) note, the ability of local governments to intervene directly in the economic field is limited, partly due to budgetary considerations. According to Brusco and Righi (1989):

> The industrial policy carried out at the local level is not directed to the single firm but to the system of firms and tends to equip the sector with those capacities which it cannot supply through its own means. ...these interventions have always been carried out at a comparatively low cost. They have been based on creative ideas and good management rather than on any large funding capacity. (Brusco and Righi, 1989, p.420)

Thus, policy intervention in the Emilian model should be viewed as facilitative, aiming at the provision of collective services to the small firm community rather than the targeting of individual firms. This approach holds true for both the 'red' and 'white' districts although the 'red' ones exhibit higher levels of budget deficits and debts (Trigilia 1986). In addition to economic intervention, local governments are active in the provision of social services such as transport, housing and child-care services (Brusco 1982) creating what Trigilia (1986) terms a 'local social wage'. Intervention of this kind in welfare provision is crucial since it serves to enhance existing network structures (Trigilia 1986).

Because of the strategies pursued by the small firms supported by the local-level policies, small firms in the industrial district are offering high wage-employment opportunities. As Pyke and Sengenberger (1992) point out, small firms in the Emilian districts have pursued "...the 'high road' of constructive competition, based on efficiency enhancement and innovation; that is, through economic gains that make wage gains and improvements in social conditions feasible...." (Pyke and Sengenberger, 1992, p.12) This contrasts with the strategy often pursued by small firms of competing through low labour costs and a deregulated market. Small firms in Emilia Romagna have moved into high value-added segments of traditional markets and maintained competitiveness

through a high degree of flexibility combined with a continuous commitment to innovation. This process of sectoral upgrading has been crucially assisted by 'institutional thickness' or the embeddedness of small firm networks.

In conclusion, it could be argued that there are striking similarities between the Emilian and the Mondragon models in what has been described as 'institutional thickness', that is networks of firms embedded in cultural-historical territorialities with a density of institutions providing collective services to systems of firms. It is precisely this 'institutional thickness' that allows small firms to compete constructively rather than relying on sweated labour to gain competitive advantage. There are, however, differences. In the Mondragon model, firms and institutions are linked through common co-operative ownership whereas in the Emilian model direct ownership links between firms are absent. Thus, Mondragon is best described as an intra-firm network whereas the Emilian industrial districts represent inter-firm networks. A common feature is, however, the porous nature of firm boundaries and the associated flexibility. A second difference lies in the role of local governments in the shaping of the districts which is important in the Emilian case but absent in Mondragon. Policies to support the development of firms originate from the co-operative institutions in the Mondragon complex, whereas in the Emilian case they are developed in and delivered through a myriad of public-private organisations. In the Mondragon case, these policies are highly interventionist targeting a limited number of new firms or, put another way, policies are qualitative. In the Emilian case, intervention is less dirigiste and focuses more on maintaining the equilibrium between firms in the private sector and institutions. However, both approaches are market-oriented, seeking to intervene where market imperfections are evident. Common to both models is also a concern for combining economic development with social policy goals, illustrated by the social welfare policies pursued. Although Emilia Romagna and Mondragon represent cases of successful small firm development and performance, the transferability of policy from the two models

might be limited due to the above outlined embeddedness of policies and institutions in local cultural contexts. The last section will look at the West Midlands model.

### 3.4. The West Midlands model of industrial decline

The past two decades have witnessed a remarkable industrial decline in Britain, once the leading manufacturing country of the world. The West Midlands, as the heartland of the industrial revolution, suffered more than other regions in Britain from the decline in traditional manufacturing sector (Advantage West Midlands 1999, Marshall 1990). Research in the 1970s into the role of small firms as vehicles for job creation (Bolton 1971, Birch 1979) brought about new interest as to whether there should be a small firm policy in order to better utilise this job creation potential in the light of economic recession and mass unemployment in the UK in general, and the West Midlands in particular.

As in many other European countries, the small firm sector in the UK experienced substantial growth from the 1970s onwards, albeit with different dynamics and with differing antecedents compared to other regions and countries within Europe. Although, as Storey and Johnson (1987) point out, the motivating factors should not be simplified by adapting a mono-causal explanation, there appears to be sufficient evidence in the literature pointing towards a factor that predominantly influenced the resurgence of the small firm sector in many regions of the UK and the West Midlands in particular. As already indicated, interest in the role of small firms arose at a time when traditional manufacturing industries experienced rapid decline accompanied by the shedding of thousands of jobs. The West Midlands was particularly badly hit by the developments in the 1970s up to the 1980s, with many of the large manufacturing companies downscaling or closing (Elliott and Marshall 1989). Thus, the resurgence of small businesses was attributed, by many authors, to the so-called "recession-push" factor (Keeble and Wever 1986). It has been argued that "... the absolute growth of self-

employment and the relative growth in small firms in areas such as Birmingham and the UK as a whole is a reflection of industrial weakness rather than that of renewed strength." (Storey and Johnson 1987, p.126).

Other evidence is supportive of the argument that small firm sector development is largely following the self-employment trajectory with overwhelming emphasis on petty services (West Midlands Business Survey 1992). Hughes (1993) goes on to argue that the increase in the number of small scale establishments is primarily due to massive employment losses in large firms rather than an increase in employment in small firms (see also Elliott and Marshall 1989).

Another aspect that distinguishes small firms in the West Midlands from its European counterparts can be derived from the "high road" versus "low road" analysis of increasing competitiveness advocated by Pyke and Sengenberger (1992). Whereas in the Emilian and Mondragon models small firms compete in high value-added niche markets utilising size-related flexibility and technology to maintain competitiveness, in many areas of the UK, the West Midlands included, a deregulated labour market and cheap labour form the basis for competitiveness (Elliott and Marshall 1989, Marshall 1990, Rainnie 1989). Small firms tend to operate in what can be described as commodity segments of the market, competing mainly on price rather than non-price criteria. Low costs, in particular labour, are of prime importance and hence income growth is slow.

Small firm policy is another distinguishing feature of the West Midlands model. Local and regional policies in the UK are largely constructed around national policy schemes (Elliott and Marshall 1989). These schemes have been largely seeking to address generic constraints on small firms such as the financial gap or the management gap. Thus, initiatives such as the Enterprise Allowance Scheme, the Business Expansion Scheme and the Loan Guarantee scheme have focused on the provision of financial services whereas the Training and Enterprise Councils, the Consultancy Initiative and

Business Links focus on the delivery of what has previously been described as 'real' services. A key characteristic of the West Midland model in the 1980s has been, excepting a few sectoral and firm specific initiatives[16], the unselective nature of policy. The largest spending scheme of the government, the Enterprise Allowance Scheme, targetted unemployed people by giving an incentive to become self-employed. Some researchers argued that, except for the small training element involved in entering the EAS, it was simply a substitute for unemployment benefit (Bannock and Albach 1991). Virtually all unemployed people seeking to set up their own business are eligible for funding contingent on the production of a business plan. The unselective nature of policy, or what was termed the 'quantity approach' in chapter 2, is also evident in other schemes such as real service provision.

A number of problems associated with this approach were highlighted in the UK context. Firstly, evidence suggests that, upon removal of financial subsidies, assisted small firms exhibited a high failure rate (Storey 1994, Turok 1994). A second related critique points to the high displacement effect of policies. Small firms in the UK tend to start up in sectors with low barriers to entry which often exhibit a high degree of sectoral overcapacity.[17] The effect of subsidised entry of new firms into such 'saturated' markets has been the exit of firms that do not benefit from this type of support.[18] Furthermore, unselective policy inadvertently supported enterprises' strategies following the 'low road" to competitiveness:

> It is not merely that each entrant encouraged displaces an existing firm: by increasing the tendency to overcapacity, prices and profits are lowered, reducing investment in fixed capital, training and innovation, and thus inhibiting the

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[16] Sectoral initiative include for example the development of science parks in the regions based on close linkages between technology-based firms and university research departments. The Wolverhampton University Science Park is largely based on IT businesses, particularly multimedia.

[17] Following Burkitt and Bateman (1990), the idea of 'saturated' markets lends itself as a useful concept to describe the typical small firm environment in the West Midlands. This conceptualisation will be explored more fully in chapter 4.

[18] Research has shown that the displacement effect in sectors such as beauty and hairdressing is nearly 100 percent (*Financial Times* 1992).

> qualitative development of the sector as a whole; this in turn keeps the sector the domain of small, undercapitalised firms. (Eisenschitz and Gough, 1993, p.92)

A third problem with unselective support is the 'deadweight' issue, that is to say, firms taking up policy measures because 'they are available'. Taking the example of the Enterprise Allowance Scheme, the Department of Employment originally estimated that about half of the recipients would have started up in the absence of the scheme. This was later on revised to 67 per cent (Storey 1994). Lastly, very few of the assisted firms were growth-oriented (for a summary see Storey 1994).

These shortcomings of the quantitative approach in the UK context have led to calls for a more selective approach to small firm policy, targeting the small percentage of 'growth' firms in the UK economy (Storey 1994, Mole and Hassall 1999). However, selective policies are not unproblematic. Firstly, a selective approach is inappropriate for start-ups since it is impossible to predict 'future' successful firms with any acceptable level of accuracy (Storey 1994). Secondly, even when accepting the need to target existing firms the problem of targeting criteria remains. Smallbone (1997) concludes from a study of manufacturing SMEs in South London that growth orientation and performance are sounder criteria to use in targeting firms compared to age or sector. However, such an assessment requires in-depth information on small firms far beyond the current capabilities of existing databases (Smallbone 1997, Mole and Hassall 1999). In the light of these difficulties, a two-pronged approach that combines support services focusing on the needs of all firms with a a more selective targeting of winners, through a variety of tailored policy measures, is being advocated (Smallbone 1997).

The above analysis of the West Midlands model of small firm development suggests that whilst there are fewer concerns about the culture-specific context of policies (i.e. problems of transferability), there remains a serious question mark as regards the efficiency and effectiveness of small firm policies. The West Midlands policy

experience of the 1980s, with policies carrying high displacement and deadweight costs, may not necessarily be considered as a 'best practice' example to be emulated elsewhere.

Summing up, the models described above illustrate the diversity and relative performance of small firms in the Western European context. Marked differences exist as to the underlying causes for the resurgence of small firms in the three models on the one hand and their strategies for seeking to increase competitiveness on the other. Whereas in the Emilian and Mondragon models small firms built on either agricultural or proto-industrial structures to develop a flourishing entrepreneurial region, small firms in the West Midlands emerged in the process of the decline of traditionally competitive, large firms. The Emilian and the Mondragon models depict cases where small firms are the prime movers in the industrial and also the social development of the region. In the West Midlands, however, small firm sector development appears to be primarily an indicator for industrial decline and the development of petty service related activities.

The second difference that can be observed in the three models are the strategies pursued to increase the competitiveness of small firms. The Mondragon and Emilian models are committed to develop their strengths in high value-added niche markets by a continuous commitment to innovation and training of highly-skilled labour. Both models are also characterised by a strong export orientation of its firms. Networking is instrumental in sustaining competitiveness. In sharp contrast stands the West Midland model where competitiveness is based on the exploitation of cheap labour in a deregulated labour market, in other words, the so-called "sweatshop" phenomenon. Using the Pyke and Sengenberger (1992) analysis of "high road" versus "low road" to competitiveness, the evidence suggests that Mondragon and Emilia-Romagna illustrate the former whereas the West Midlands model falls into the latter category. Whilst both are possible strategies, the "high road" seems to be the more appealing one. Firstly, competition is highest in commodity segments of markets and cheap, unskilled labour can be considered one such commodity. Therefore, any firms that develop strategies

based around 'sweated labour' face intense competition from low-cost countries whereas strategies based around skilled labour and sectoral upgrading through technological development are likely to yield innovation rents. Secondly, the 'high' road is preferable in the sense that it leads to higher sustainable income growth. However, in highlighting the advantages of 'high road' competitiveness we have to consider the reservations by some observers (Eisenschitz and Gough 1993) as to the applicability of such strategies to *all* regions.

The policies allied to the three models reflect the above influences and strategies. Both the Mondragon and Emilian policies aim at the enhancement and development of existing organisational and institutional factors building upon indigenous strengths. In both cases the focus of policies is on networks rather than individual firms. West Midlands policies, in contrast have, by and large, focused on creating large numbers of small firms by lowering barriers to entry. The underlying rationale has been based on the misconception that more firms necessarily mean more job. As has been shown, the failure rate of ventures, once subsidies were removed, is high and there is significant evidence of displacement in the context of saturated markets and deadweight. Thus, preliminary assessments of West Midlands policies considered the approach inappropriate and not cost-effective. Research also seems to indicate that a more targeted approach to individual small firms is fraught with forecasting problems. One alternative would be to focus on already established businesses with growth potential. However, the Emilian and Mondragon examples show that the support of networks rather than of individual firms is another policy alternative.

Using the concept of 'institutional thickness', both Mondragon and Emilia Romagna evidence the embeddedness of networks of firms and institutions. However, in the West Midlands case, despite a plethora of small business support institutions and schemes there is little evidence of the embeddedness of small firms (Szarka 1990). Thus, the existence of institutions *per se* is not a useful indicator to judge the availability of

network capital (Amin and Thrift 1995). Crucial to the small firms becoming embedded are socio-cultural factors. In the case of many UK regions, the concept of 'enterprise culture' reborn under the Thatcher era, with its emphasis on individual rather than collective entrepreneurship, is pervading socio-cultural norms and reflects a crucial missing link in the emergence of embedded networks of the Emilian or Mondragon type.

The analysis of the three West European models of small firm development has shown that a policy transfer of the Western experience to Eastern Europe might a priori be problematic. Problems arise out of the local cultural and institutional context within which policies are embedded and /or because the policy experience in the West cannot be considered good practice. Nonetheless, there may be scope for serious consideration of elements of one or more of these models and this is taken up in chapter 8. Before this can assessed, it is necessary to explore the analysis of the role of small firms and small firm policies in the context of transition economies, with particular focus on Russia and Hungary. Thus, having looked at the policy frameworks in developed market economies, the following chapter seeks to analyse the role of small firms and small firm policies in the context of transition economies. This is then followed by the case studies of Russia and Hungary.

## Chapter 4: The role of small firms in transition economies

Whilst in Central and Eastern Europe there appears to be a broad consensus, at governmental and international donor level, for the need to stimulate SME development, there is some disagreement among academic observers on that issue. Some observers have called for a strategy of 'starting over in Eastern Europe' (Johnson and Loveman 1995, see also Richter and Schaffer 1996), based on liberalising the dynamic forces of entrepreneurship to replace the organisation of work under the communist system which is seen as "...no longer sensible or functional." (Johnson and Loveman, 1995, p.217). Whilst the need to restructure large state-owned enterprises (SOEs) is acknowledged, this is seen in the context of providing further impetus to the development of new small firms which are seen as the powerhouse driving economic growth (Johnson and Loveman 1995, Richter and Schaffer 1996).

Yet there have been strong arguments dismissive of such logic:

> National and local policy-makers and academics have been fascinated by the possibility of a growth of small and medium sized enterprises, but much of the recent enthusiasm here seems based on wild generalisations from questionable examples drawn eclectically from across the world. Small and medium firm development cannot be an alternative to a healthy large firm sector for it depends heavily on it - indeed is to an extent parasitic on it - and a healthy dose of scepticism is required when it is offered as a panacea. (Haynes, 1996, p.471)

The reality of small and medium entrepreneurship in Eastern Europe is more complex than the above arguments allow for and neither extreme view is helpful in understanding

the role of SME development in the transition economies. In order to shed light on the complex issue of the role of SMEs in transition economies, this chapter provides an overview of the theoretical debates and empirical evidence relating to SMEs in transition economies in general. The first section conceptualises three environments influenced by the rate of new small firm entry. This concepualisation is helpful in understanding the distinctiveness of small firm development in transition economies as opposed to small firm development in developed market-type economies. The following sections seek to position small firm development in the context of broader reform issues. The value of small firm development to both macroeconomic and microeconomic policy goals will be explored.

## 4.1. Unsaturated versus saturated market structures – a conceptualisation

The centrally-planned economies of Central and Eastern Europe (CEE) have been associated with size-structure imbalances in industry and other sectors of the economy.[1] The tendency to promote large-scale enterprises in virtually monopolistic positions was rationalised by policy-makers along the following lines:

- Policy-makers held the strong belief that only large units can fully reap the benefits from economies of scale, a view that reflects a glorification of Fordist and Taylorist principles (Roman 1989, Newbery and Kattuman 1992).

[1] The centrally-planned economies have been characterised not only by size but also other distortions at the macro-and microlevels. For a discussion see Stiglitz 1994, Nove 1983, Gros and Steinherr 1995.

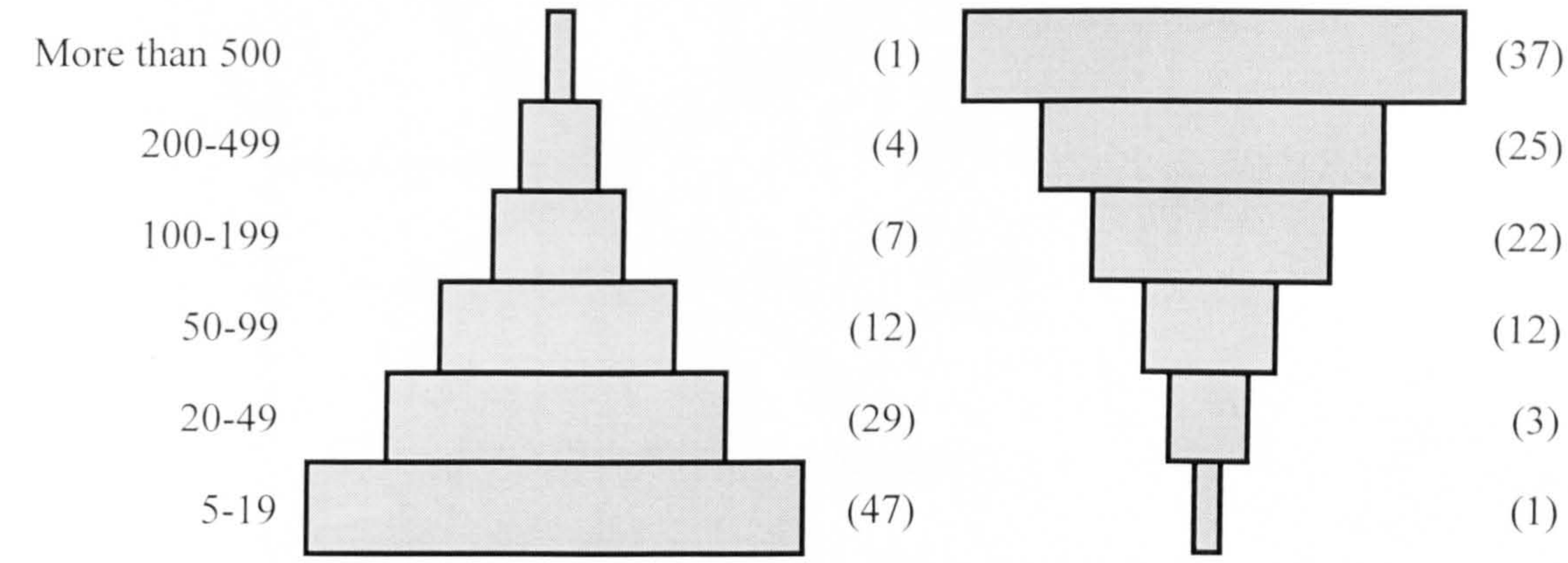
However, the pursuit of scale *per se*, influenced not by the market mechanism but by a hierarchical planning body, neglected the emergence of diseconomies of scale. Furthermore, as Amsden et al. (1994) and Myant (1997) show, despite the obsession of central planners with scale, many enterprises were below optimum scale. The key issue here is that, in the absence of effective competition, any comparisons as regards minimum efficient scale became impossible. In the light of central planners facing such information problems, distorted size structures emerged. The application of the structure-conduct-performance paradigm informs us of the detrimental effects of such structural distortions on the performance of enterprises (Nove 1983). For example, McDermott and Mejstrik (1993) in a study on Czech manufacturing reveal a negative correlation between size of firms and performance.

- Central planning itself favoured the trend towards gigantism since it was relatively easier to plan for a limited number of large firms rather than seeking to accommodate a myriad of small firms in central plans (Roman 1989, Newbery and Kattuman 1992). At the heart of the issue lie information problems that central planners face. Stiglitz (1994) argues that the information problems of central planners go beyond what the Austrian economists (for example Hayek and von Mises) have identified as the processing of information and also include the identification and collection of the right kind of information. One way in which central planners have sought to overcome these dilemmas is by limiting the number of units that needed to be accommodated in the plans. In addition to the resulting structural problems, however, deficiencies associated with hierarchical centralisation (lack of flexibility, for example) became evident (Murrell 1990, Stiglitz 1994).

- The third factor was ideological rather than economic. In the eyes of policy-makers and the public alike, small firms were generally associated with private ownership and/or black market activities and were thus an anathema to socialist values (Barath and Szalo 1990, Falus-Szikra 1985, Kallay et al. 1992). Any attempts to introduce a limited SME sector in centrally-planned economies (such as in Hungary in the 1960s and 1980s or the Soviet Union in the 1980s) have carefully emphasised the non-private, non-exploitative character of such ventures. Thus, co-operatives became a favoured enterprise format during reform periods under socialism.

Following this rationale, planners proceeded to favour policies that restricted the entry of new firms and merged existing ones. The outcome of such policies was the emergence of a 'socialist black hole' (Vahcic et al. 1988), that is, the relative absence of small firms in the economy. Comparing the size structure of centrally-planned economies with that of market-type economies, an 'inverted pyramid' is typical of the East European case (see diagram 4.1.). This highlights the predominance of large-scale units over small-scale ones in terms of their contribution to employment and output.

Diagram 4.1: Break-down of firms according to employment

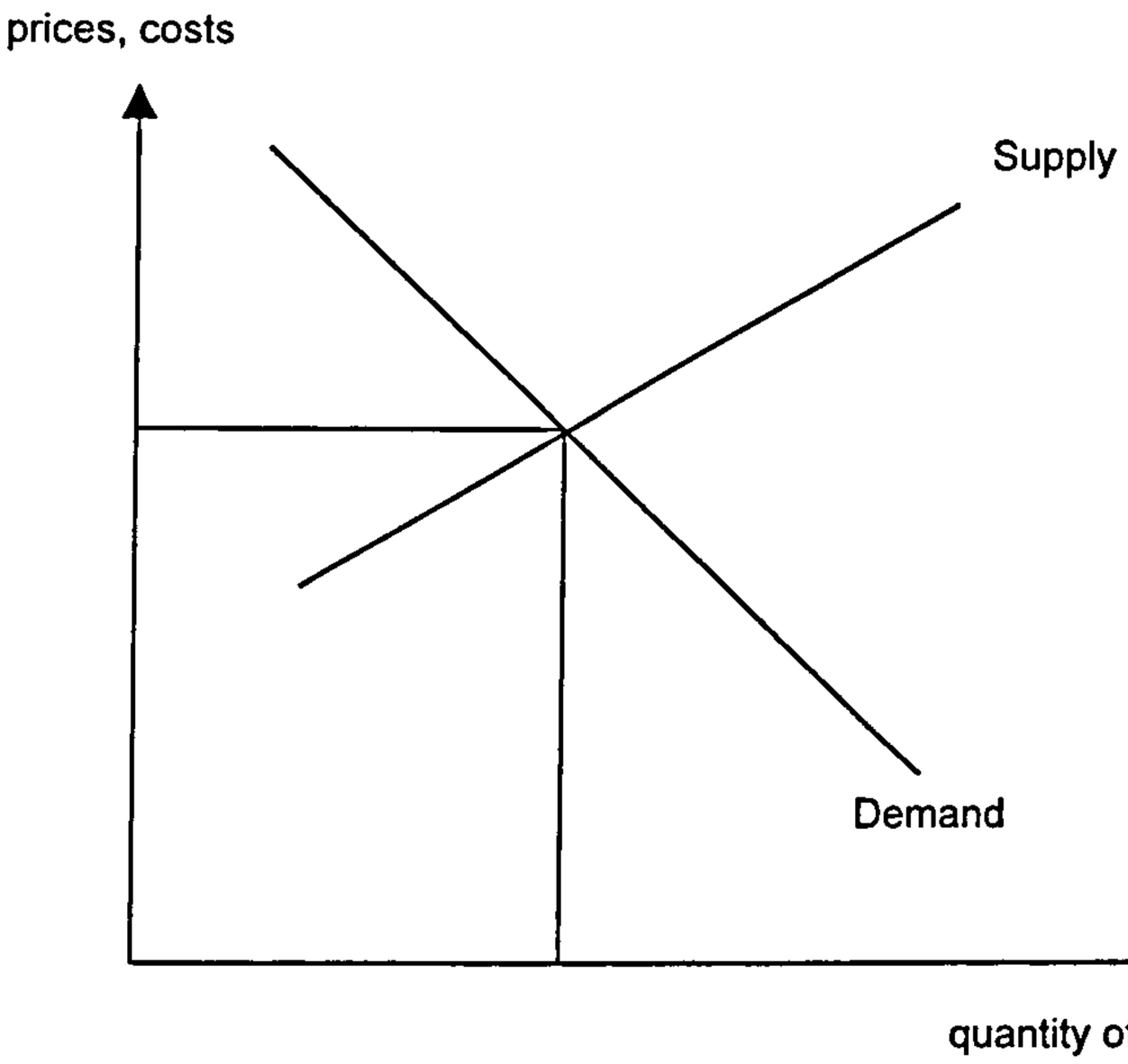



Source: Schweitzer, 1982, p. 130 as quoted in Hoggett and Kállay 1983

Burkitt and Bateman (1990) provide a useful framework for the conceptualisation of market structures in respect of small firm populations in a locality. Three different environments are introduced, taking new firm entry as a variable.[2] In the first scenario, market structures are unsaturated as a result of pervasive barriers to entry. Structural disequilibrium is evident with the supply of goods typically provided by small firms being limited (see diagram 4.2). Despite the evident profit premiums, the persistence of entry barriers prevents the attainment of equilibrium conditions.

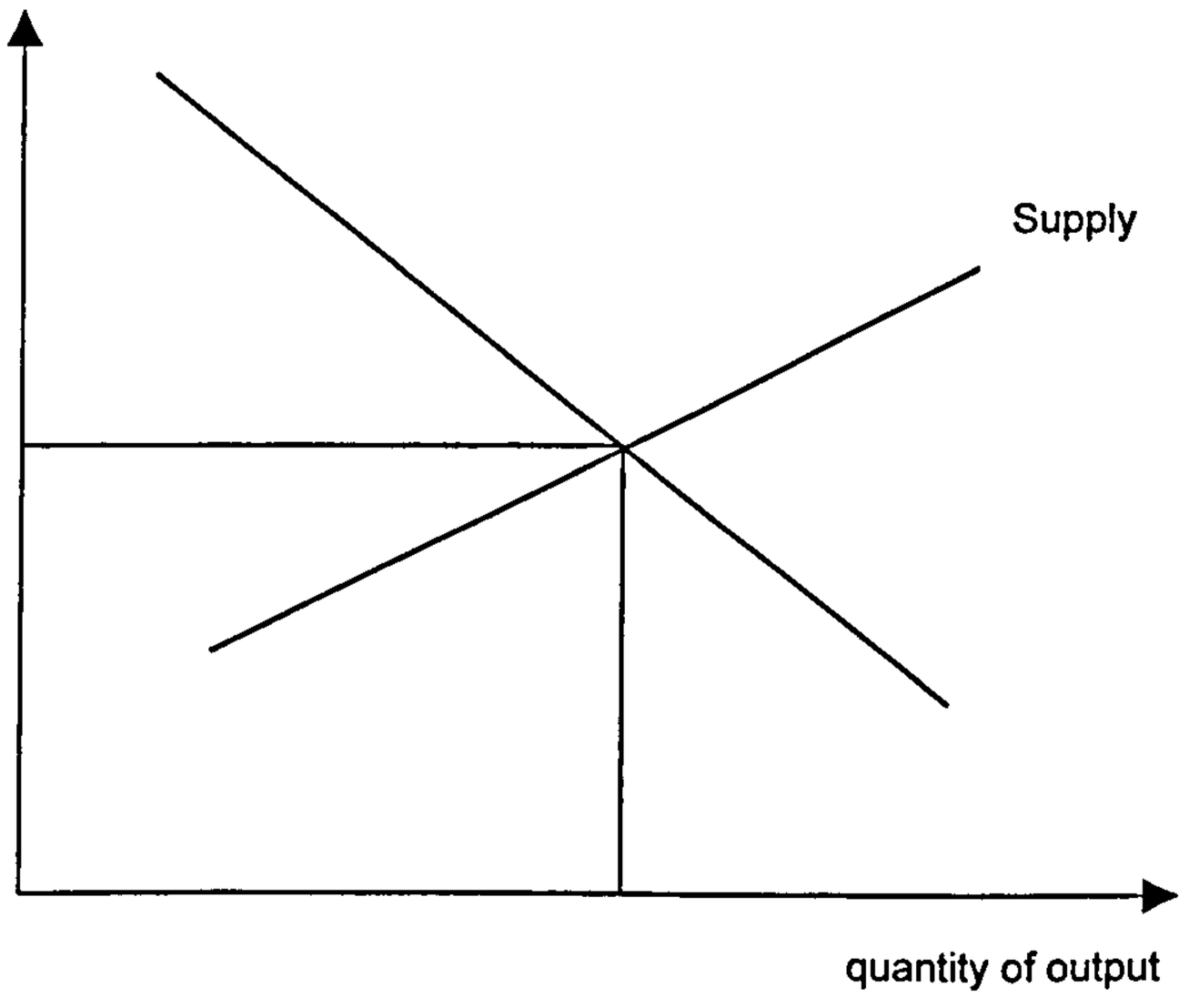
[2] There are some assumptions to this conceptualisation. Firstly, it is assumed that an exogenously determined wage prevails in the local economy. Secondly, the level of demand for goods produced by small firms is taken as a constant.

Diagram 4.2: The unsaturated market structure



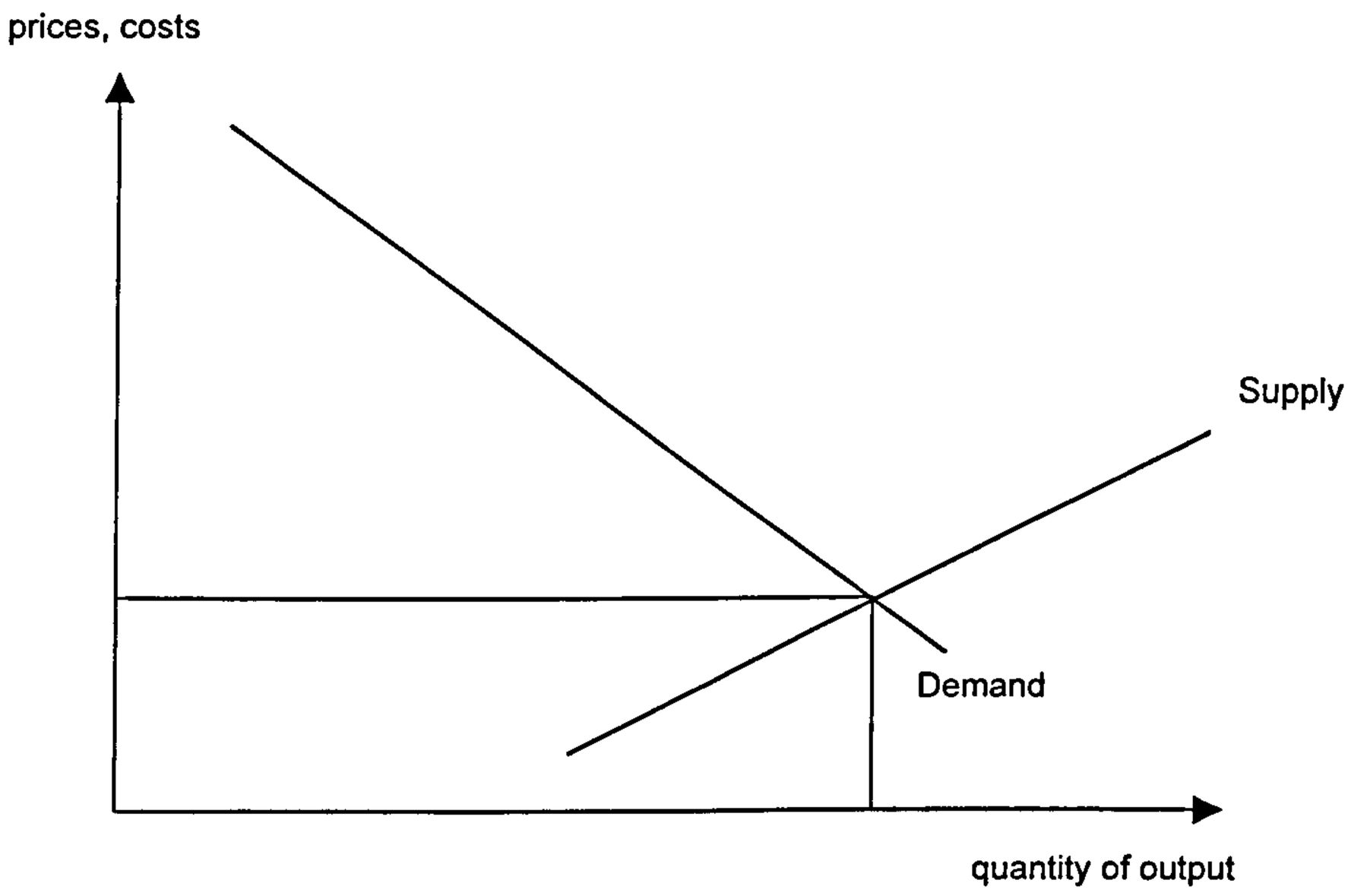

Upon removal of entry barriers, the second environment, mature market structures, materialises (see diagram 4.3.). This environment is characterised by easy entry and exit of small firms based on perceived profit opportunities as depicted in neo-classical models.

Diagram 4.3: The mature market structure



The third environment, saturated market structures (see diagram 4.4.), emerges when there is an overshoot of new entry of small firms (caused, for example, by subsidised new entry, see chapter 3). In this case, existing profit opportunities are reduced as a result of excessive supply in relation to demand. The results are typically low investment activity and a high rate of exits.

Diagram 4.4: The saturated market structure




The first scenario, unsaturated market structures, encapsulates the reality of the prevailing environment in the command economies. There, despite supply-side constraints, small firms were prevented from emerging through the persistence of entry barriers in the official economy.[3]

[3] Barriers to entry in the official economy did not prevent the emergence of an informal economy (in a variety of manifestations) which will be explored below. However, the informal economy cannot be regarded as a perfect substitute for an official economy (Gros and Steinherr 1995), and therefore does not seriously influence this conceptualisation.

The effects of perverted size structures manifest themselves in supply-side constraints, lack of relevant technological innovation and poor international competitiveness (McDermott and Mejstrik 1993, Newbery and Kattuman 1992, Audretsch 1993). A major challenge for the countries of the region during transition was to reverse these trends and bring their economies in line with Western market-type economies.

## 4.2. Small firm sector development in the context of transition

The fall of the Berlin Wall in 1989 heralded the beginning of a new era in Central and Eastern Europe with countries seeking to reform their economies through systemic changes from centrally-planned to market-type economies. The initial debate on systemic transformation focused largely on the speed with which reforms were to take place. On the one hand, proponents of Big Bang or shock therapy reforms advocated a radical break with the past through sweeping overnight changes to the existing system. Their focus was mainly on liberalisation accompanied by prudent fiscal and monetary policies, and mass privatisation. The other camp, gradualist reformers, emphasised the need for a more paced approach that would take into account the long-term restructuring needs of the economies. However, some authors have argued that the discussion about speed of reform is largely political in nature (Lavigne 1995) and that the underlying theoretical constructs of neo-liberal monetarism have been almost unquestioningly accepted throughout the region (Smith and Pickles 1998). The troika of reform measures - liberalisation, stabilisation and privatisation - has been viewed as the swiftest way of not only achieving systemic change but also of laying the foundations for long-term

international competitiveness of the Central and East European economies. The initial results of reform measures, however, were disappointing, as the following data indicate. In the monetary field, whilst the end of queues signalled the emergence of effective market-clearing prices, inflation rose drastically and proved difficult to control.

Table 4.1: Inflation in selected Central and East European countries (change in the year-end retail/consumer price level, in per cent)

| | 1991 | 1992 | 1993 | 1994 | 1995 | 1996* | 1997** |
|---|---|---|---|---|---|---|---|
| Bulgaria | 339 | 79 | 64 | 122 | 33 | 311 | 592 |
| Czech Republic | 52 | 13 | 18 | 10 | 8 | 9 | 9 |
| Hungary | 32 | 22 | 21 | 21 | 28 | 20 | 17 |
| Poland | 60 | 44 | 38 | 29 | 22 | 19 | 15 |
| Romania | 223 | 199 | 296 | 62 | 28 | 57 | 116 |
| Russia | 144 | 2,501 | 837 | 217 | 132 | 22 | 14 |
| Slovak Republic | 58 | 9 | 25 | 12 | 7 | 5 | 7 |
| Slovenia | 247 | 93 | 23 | 18 | 9 | 9 | 9 |
| Eastern Europe and the Baltic States*** | 193 | 510 | 166 | 35 | 19 | 38 | 65 |
| The Commonwealth of Independent States**** | 139 | 1,672 | 4,584 | 1,387 | 363 | 63 | 33 |

* Estimate for 1996
** Projection for 1997
*** Unweighted average for Albania, Bulgaria, Croatia, the Czech Republic, Estonia, FYR Macedonia, Hungary, Latvia, Lithuania, Poland. Romania, the Slovak Republic and Slovenia
**** Unweighted average for all countries of the Former Soviet Union, except Estonia, Latvia and Lithuania

Source: European Bank for Reconstruction and Development 1997

The results in the fiscal field were also not very positive. Whilst there has been some progress in the Central European countries towards controlling deficits, the Former Soviet Republics rely heavily on domestic and international borrowing to dampen the inflationary effects of burgeoning deficits. Moreover, the tax burden on enterprises is

often at unacceptably high levels as governments are seeking to plug deficits through a broadening and deepening of the tax regime (EBRD 1997). This leads to a "Catch 22" situation where enterprises are avoiding tax payments, thus creating the need to maintain high levels of taxation. To fundamentally address the problem, there is a need to improve tax discipline. This might be difficult, given what some authors describe as the paralysis of state institutions (Haynes 1996, Rutland 1996), that is, the political (and often legal, see chapters 5 and 7) inability of governments to enforce tax payments.

The benefits and outcomes of the third cornerstone of economic reform, privatisation, are also questionable. Whilst there has been a growth of private sector share in GDP, these data have to be viewed with caution. Firstly, official statistics on private sector development incorporate the growth of *de novo* private firms in addition to enterprises that have undergone formal privatisation. Secondly, these data, in some countries, include enterprises that have been only partially privatised with the state maintaining a significant holding in the companies (Pedziwol 1997). Furthermore, complex cross-ownership links make the identification of ownership and control perilous. The case of the Czech Republic demonstrates that, where the unravelling of ownership ties leads back to the state-owned National Property Fund (Pedziwol 1997). What is more critical, however, is the performance of newly-privatised firms. While some studies appear to show the superior performance of privatised enterprises in comparison to state enterprises, selection bias puts these results into question (EBRD 1997). Recent research into the performance of private firms in Eastern Europe suggests that privatisation of SOEs yields limited benefits in terms of encouraging market-oriented behaviour (Chance 1999, Richter and Schaffer 1996). Filatotchev et al. (1999) have demonstrated

the limited restructuring of especially insider-controlled privatised firms, a favoured ownership format in many privatisation programmes in Eastern Europe (Estrin 1994). Thus, neither theoretical arguments nor the empirical evidence are convincing of the merits of privatisation *per se* in initaiting structural reforms (Stiglitz 1994).

Restructuring at the microlevel was thought to be influenced, in addition to the remedial shock of privatisation, by Foreign Direct Investment (FDI). Such investment held the promise of not only injections of capital that was scarce at the domestic level, but also the transfer of technological and managerial know-how which was seen as a key supply-side constraint (Meyer 1998). However, inflows of FDI into the region have been modest and with significant spatial differentiations (see table 4.2.).

Table 4.2: Foreign Direct Investment in selected Central and Eastern European countries (net inflows recorded in the balance of payments)

| | Cumulative FDI-inflows 1989-1996 (million US $) | Cumulative FDI-inflows 1989-1996 per capita (US $) | FDI-inflows per capita in 1996 (US $) | FDI-inflows as a share of GDP in 1996 (%) |
|---|---|---|---|---|
| Bulgaria | 425 | 51 | 12 | 1 |
| Czech Republic | 7,120 | 692 | 123 | 2 |
| Hungary | 13,260 | 1,300 | 195 | 4 |
| Poland | 5,398 | 140 | 71 | 2 |
| Romania | 1,186 | 52 | 9 | 1 |
| Russia | 5,843 | 40 | 14 | 0 |
| Slovak Republic | 623 | 117 | 33 | 1 |
| Slovenia | 743 | 372 | 90 | 1 |
| Eastern Europe and the Baltic States | 31,408 | 273 | 66 | 2 |
| The Commonwealth of Independent States | 12,480 | 44 | 17 | 1 |
| **Total** | **43,888** | **110** | **31** | **1** |

Source: European Bank for Reconstruction and Development 1997

Meyer (1995) has argued that the level of income, and the related demand for more sophisticated consumer goods, are key determinants for the variations in FDI in the region rather that the size of the market *per se*. Halligan and Teplukhin (1995) view the inability of East European countries (in particular Russia) to attract significant amounts of FDI in the framework of investment disincentives, highest amongst which rank legal and economic disincentives. Lankes and Venables (1996), in a survey of foreign investors, suggest that the regional variations in FDI are linked to the degree of structural reform in the host country. The data available[4] also support the view of some

[4] See Meyer (1995) for a detailed discussion of the sources of statistical information.

authors who have argued that FDI is more likely to follow growth rather than act as a catalyst for it (Amsden 1995). However, even if FDI flows were more voluminous, the expected benefits in terms of resource transfers and multiplier effects have to be viewed with scepticism. As regards technological upgrading, Lall (1996) points out that the innovative activities of MNC's tend to be concentrated in a few developed countries. Based on empirical evidence from developing countries, he goes on to argue that the presence of multinational enterprises can even act as a deterrent to the development of R&D capacity of indigenous firms. Furthermore, the spillover effects anticipated from multinationals to the host economy through local supplier networks, in the absence of relevant and effective policy intervention, are often exaggerated, with the foreign enterprise being the typical 'cathedral in the desert' (Grabher 1992).

When looking at the overall economic performance of Eastern Europe over the last decade, the decline in output is striking, even if one allows for problems with official data collection and the less-documented rise in the unofficial economy.[5]

[5] See EBRD (1997) on the size of the informal economy in Central and Eastern Europe.

Table 4.3: Growth in real GDP in Central and Eastern Europe (in percent)

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996* | 1997** |
|---|---|---|---|---|---|---|---|---|
| Bulgaria | -9.1 | -11.7 | -7.3 | -2.4 | 1.8 | 2.1 | -10.9 | -7.0 |
| Czech Republic | -1.2 | -11.5 | -3.3 | 0.6 | 2.7 | 5.9 | 4.1 | 1.0 |
| Hungary | -3.5 | -11.9 | -3.1 | -0.6 | 2.9 | 1.5 | 1.0 | 3.0 |
| Poland | -11.6 | -7.0 | 2.6 | 3.8 | 5.2 | 7.0 | 6.0 | 5.5 |
| Romania | -5.6 | -12.6 | -8.7 | 1.5 | 3.9 | 7.1 | 4.1 | -1.5 |
| Russia | -4.0 | -5.0 | -14.5 | -8.7 | -12.6 | -4.0 | -5.0 | 1.0 |
| Slovak Republic | -2.5 | -14.6 | -6.5 | -3.7 | 4.9 | 6.8 | 6.9 | 4.5 |
| Slovenia | -4.7 | -8.9 | -5.5 | 2.8 | 5.3 | 4.1 | 3.1 | 4.0 |
| Eastern Europe and the Baltic States | -6.8 | -10.6 | -4.2 | 0.4 | 3.7 | 5.3 | 4.1 | 3.1 |
| The Commonwealth of Independent States | -3.7 | -5.8 | -14.3 | -9.3 | -13.5 | -4.9 | -4.6 | 0.8 |
| Eastern Europe, the Baltics and CIS | -4.9 | -7.7 | -10.3 | -5.3 | -6.6 | -0.8 | -1.1 | 1.7 |

*Estimate
**Projection
Source: European Bank for Reconstruction and Development 1997

However, there are marked differences in the degree of output decline and the pace of the subsequent recovery, influenced by a complexity of political, cultural, social and economic factors. After a period of decline, the Central European economies recovered and resumed growth. Nevertheless, according to the United Nations Economic Commission for Europe, even the fastest growing economies (with the exception of Poland) have not yet reached 1989 levels of output (UN/ECE 1997). This is particularly alarming in the light of the fact that the rest of the world has since moved on in terms of growth. The Czech Republic, for example, will take 10 years to reach 70 percent of the European Union average GDP if it achieves 5 percent annual growth while the EU achieves only 2 percent (Myant 1997). The picture is even bleaker when looking at the

some of the Balkan countries and the Former Soviet Republics where output decline has been steepest and signs of recovery are weak.

Another concern that has to be raised is in respect of growth dynamics. Much of the initially recorded productivity growth has been based on what can be termed 'shallow restructuring' which involved little more than the shedding of excess labour (Filatotchev et al. 1999). High levels of unemployment have resulted from this, as table 4.4. illustrates.

Table 4.4: Registered unemployment in selected transition countries, 1990, 1992-1996 (end of period, in percent)

| | 1990 | 1992 | 1993 | 1994 | 1995 | 1996 |
|---|---|---|---|---|---|---|
| Bulgaria | 1.8 | 15.6 | 16.4 | 12.8 | 11.1 | 12.5 |
| Czech Republic | 0.7 | 2.6 | 3.5 | 3.2 | 2.9 | 3.5 |
| Hungary | 1.7 | 12.3 | 12.1 | 10.9 | 10.4 | 10.5 |
| Poland | 6.5 | 14.3 | 16.4 | 16.0 | 14.9 | 13.3 |
| Romania | 1.3 | 8.2 | 10.4 | 10.9 | 9.5 | 6.3 |
| Russia | - | 4.7 | 5.5 | 7.5 | 8.9 | 9.3 |
| Slovakia | 1.6 | 10.4 | 14.4 | 14.8 | 13.1 | 12.8 |
| Slovenia | - | 13.3 | 15.5 | 14.2 | 14.5 | 14.4 |
| Total Eastern Europe | - | 5.4 | 6.6 | 6.9 | 7.5 | 7.8 |

Source: UN/ECE 1997

The EBRD (1997) has suggested that only the more advanced transition economies have started a process of deeper restructuring based on productivity gains through improvements in technology and know-how, driven by new capital injections.

There has been an increasing scepticism in the literature over the reliance of transition countries on the troika of reform measures (liberalisation, stabilisation, privatisation), and in particular the shock therapy variant:

> The policy prescriptions of Mr Sachs notwithstanding, the solution to the Eastern European transformation problem needs something more than enlightened macroeconomic policy and the privatisation of state-held assets. That is, in terms of that simplest of all economic models, yes, resources must certainly be redeployed in such a manner as to attain the production possibility frontier - but, more importantly, the frontier itself must be pushed out. (Audretsch, 1993, p.281)

The creation of new small firms has to be, in addition to privatisation and sound macroeconomic policies, a cornerstone of economic reforms in the transitional economies for a number of reasons. As was argued in chapter 2, new small firms play an important role in the introduction of competitive market structures. Kornai (1990) maintained that competition is promoted primarily by the entry of new entrepreneurs rather than the privatisation of state-owned firms. Privatisation in a highly concentrated economy, even when it involves pre-privatisation restructuring[6], rarely leads to the emergence of competitive market structures. Rather, enterprises are likely to exploit their monopolistic status in the private sector. McDermott and Mejstrik (1992) describe the persistence of a coalition structure, based on a collusive monopoly of informal internal and external contacts, despite privatisation and formal break-up of enterprises. They conclude that in order to create basic competition, there needs to be an

> ...opening up *(of)* the market to foreign competition - a necessary measure which is at a primitive stage of development and will prove initially quite costly - we can open and facilitate the expansion of a domestic private sector.... the proliferation of thousands of new entrants can help demonopolise the industrial structure and strengthen tendencies toward price competition. (McDermott and Mejstrik, 1992, pp. 173 and 174, italics added)

In addition to the associated lack of microeconomic restructuring, the persistence of monopolistic structures has important macroeconomic implications. As already highlighted, countries are seeking to control inflation through the imposition of high real interest rates because, following monetarist doctrine, excessive money supply is seen as the root of inflationary problems (Schuler 1998). However, interest rates constitute a business cost and monopolistic enterprises are likely to pass on these costs in price increases to consumers. Thus, far from bringing inflation under control, interest rate increases in a monopolistic environment can perpetuate the inflationary spiral (Lavigne 1995 and 1999). The introduction of new small firms that are competing in markets with established enterprises might thus have an important stabilisation effect.

A further macroeconomic benefit of SME development in transition economies can be theorised in relation to the fiscal situation (Antosenkov 1991). The containment of fiscal deficits is a key policy objective, yet state-owned and former state-owned firms are notorious for non-payment of taxes and the accumulation of inter-enterprise arrears (which, in an accrual-based tax system, has a negative impact on the fiscal balance) (Gaddy and Ickes 1998). SMEs constitute a potential source of fiscal revenue. However,

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[6] Pre-privatisation restructuring was practised to a noticeable extent only in East Germany where the bill was footed by the more prosperous West Germany. In addition, Estonia adopted a similar approach as the

complicated tax regimes which raise compliance costs, and the high overall level of taxation, push many new enterprises into the informal sector. The core problem here, as was argued above, lies in the need to enforce payments by state-owned and former state-owned enterprises and, where appropriate, introduce and apply comprehensive reforms of the tax regime.

Lastly, evidence from market-type economies points to the role of SMEs in job creation (Birch 1979, Storey 1994). The job creation potential of SMEs is crucial in the light of the rising unemployment problem experienced in Central and Eastern Europe (see table 4.4.). The official statistics, despite painting a fairly bleak picture, fail to capture the full extent of the problem as 'hidden unemployment' is widespread (Standing 1996). The legacy of central planning is evident in the continuing practice of enterprises to hoard labour, a strategy employed to avoid the imposition of hard budget constraints (Alfandari et al. 1995). Yet as governments, in the light of a fragile macroeconomic situation and under pressure from external donor organisations, push to harden enterprises' budgets, the superfluous labour will at some point enter the ranks of the officially unemployed. The evidence thus far suggests that it is not active labour market policies that act as the driving force behind the containment of unemployment but the vigorous growth of the private sector and the employment opportunities that it generates. Boeri and Keese (1992) note that

> ...small and medium size firms have been accounting for an increasing share of total employment in most countries even before the start of current reforms but there has been an acceleration of this process. (Boeri and Keese, 1992, p.386)

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East German Treuhandanstalt to privatisation, but on a much smaller scale.

The experience of both market economies and less developed countries suggests an equally crucial role for SMEs at the microlevel during the transition period. The well-documented lack of technological dynamism of centrally-planned economies can be viewed as a function of excessive centralisation and the lack of Schumpeterian creative destruction provoked by a vibrant SME sector (Nove 1983, Dyker and Perrin 1997). Research in market economies demonstrates the innovative potential of small firms based on behavioural advantages (Rothwell and Dodgson 1994). The view that *only* large enterprises with huge R&D budgets are significant in innovation is largely mythical and not supported by evidence:

> Although larger firms may be more R&D-intensive than their smaller counterparts, the productivity of R&D apparently falls along with firm size. There is no evidence that increasing returns to R&D expenditures in producing innovative output exist. Rather, the empirical results in this paper suggest, with few exceptions, diminishing returns to R&D are the rule. (Acs and Audretsch, 1989, p.16)

In the context of transition, where incidences of successful technological transformations of industrial 'dinosaurs' are rare (Radosevic 1997), SMEs might be an important factor in a technological renaissance of the region (Dyker and Perrin 1997). Moreover, as Bateman (1997) argues, inter-firm linkages between small and large firms in the region are a crucial mechanism for the re-generation of supply chains that have been severed during the transition period. International experience informs us of the importance of supply chains in attaining internationally competitive industries (Porter 1998).

Despite these arguments in respect of the potential of SME development in transition, there remains scepticism as to the role of SMEs (Haynes 1996, Hardy and Rainnie 1996). This scepticism centres around two arguments. Firstly, critics of small firms note the emergence of street markets in Eastern Europe, and point with derision to the possibility of economic development on the back of giant car boot sales (Hardy and Rainnie 1996). Yet these development should not have come as a surprise. In the light of resource constraints, particularly the lack of capital[7], entrepreneurs were starting up in sectors with low barriers to entry that promised quick profits. Hence a proliferation of small-scale traders and service enterprises occurred that were addressing the visible supply constraints, especially in consumer goods markets. The example of China, however, shows that such petty entrepreneurship can be an important source of capital accumulation (Goldman 1994). However, important barriers to the development of SMEs remain, and the process of capital accumulation and investment by small firms remains distorted. Thus, in the light of pervasive market failures, it would be a fallacy to expect immediate change.

The second argument of sceptics centres around the parasitic subsistence of small firms in the shadow of large firms. In market economies, there are complex interrelations and networks between and within large and small firms. The nature of the architecture is a crucial determinant in the competitiveness of both large and small firms. However, under central planning, inter-enterprise links were artificially imposed and transition, and the accompanying decline in output, have ruptured many of these links. The

emergence of new, market-driven supply chains is not likely to be immediate and spontaneous.

Therefore, far from making a case for abandoning the small firm sector, the weaknesses that are currently exhibited by small firms in the region might suggest the need for the *right kind* of small firm policy, one that is capable of bringing about the theoretical welfare gains associated with new small firm development. The following chapters will investigate this issue empirically in the case of the Russian and Hungarian economies.

[7] Much of the savings of the population were eroded through inflation following price liberalisation and capital markets are still in an infant state of development.

# Chapter 5: Small firm development in Hungary and the Russian Federation: a comparison

The Russian Federation and Hungary are both examples of transition economies, yet their approach to transition differs significantly, as has been their success in developing modern market economies out of the remnants of the old centrally-planned systems. By means of a side-by-side comparison, this chapter seeks to contrast, firstly, the environments within which small firm development takes place in the respective economies. The aim here is to highlight both systemic similarities and differences as well as country-specific contexts for the emergence of entrepreneurship from a macroeconomic perspective. Secondly, using secondary data and statistical data from Central Statistical Offices (*Központi Statisztikai Hivatal* henceforth KSH in Hungary and *Goskomstat* for the Russian Federation), the size and characteristics of the small firm sectors in Russia and Hungary will be analysed. Since small enterprise development is widely regarded as a good indicator for and of microeconomic restructuring, it is reasonable to expect Hungary as the better performer in exhibiting a much more developed and robust small firm sector compared to the Russian Federation. These differences in the maturity of the small firm sector are also likely to be reflected in its role in the respective economies, and relevant indicators will be assessed. In conclusion, the chapter seeks to draw together the main similarities and contrasts in respect of the size and the structure of SMEs in the two countries, thus highlighting the serious structural weaknesses of small firms in both economies despite their different track records in macroeconomic performance.

## 5.1. Hungarian transition - the rise and fall of gradualism?

Economic transition in Hungary is commonly described as gradual[1] so far as liberalisation and institutional reform measures are concerned (Lavigne 1995). Much of the groundwork for the systemic reforms of the 1990s was already laid in the decentralisation attempts of the 1980s when prices were partially liberalised, the economy opened up to foreign trade and market-type institutions such as a tax system and a two-tiered banking system were created. Furthermore, as will be noted in section 5.3.1., the legacy of the second economy, although not entirely beneficial, provided a rudimentary experience of quasi-market conditions for Hungarian entrepreneurs. Thus, Hungarian authorities were able to built on previous experiences[2] and reforms and subsequently gauge the pace and sequencing of systemic transformation (Székely and Newbery 1993).

However, despite some of these favourable initial conditions, the economy exhibited a series of weaknesses both at the macro- and the microlevel at the outset of reforms. At the macro-level, one of the most serious constraints was the high level of foreign debt, the highest in per capita terms in the region (Oblath 1993). Subsequently, many of the reform measures have focused on the need to service the debt in order to maintain the credit worthiness of the country, thus increasing the already significant economic and social costs of transition. Further negative factors at the macro-level included inflationary pressures, lingering price distortions and an oversized and unbalanced

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[1] At the outset of the 1990s, two schools of thought, Big Bang (or shock therapy) and gradualism, emerged following largely the contrasting reform experiences of the then forerunners in transition, Hungary and Poland. The debate on the merits and demerits of either approach centred around issues of credibility and irreversibility of reforms and was largely political and intellectual in nature with shock therapy being viewed as the embodiment of monetarist, neo-classical ideals (see Sachs and Lipton 1991). However, as Lavigne (1995) notes, the debate soon shifted away from the sequencing debate as neither the need for swift stabilisation, when required, nor the medium-to long-term nature of structural reforms were seriously contested.

[2] From a political perspective it is also worth noting that the power and credibility of the communist party had already been considerably weakened in the 1980s thus eliminating the argument of irreversibility of reforms from political discourse.

budget (Székely and Newbery 1993). The collapse of CMEA trade and the subsequent loss of markets in Eastern Europe further contributed to the precariousness of the situation. At the microlevel, the Hungarian economy remained heavily concentrated despite the decentralisation attempts, with the large state-owned sector shielded from market forces through distorted prices and widespread subsidies.[3] The resulting uncompetitiveness of the Hungarian economy is best illustrated in the study by Hare and Hughes (1992) which estimated 24.2 percent of Hungarian industry to have been value-subtracting.[4] The newly-created commercial banks were extremely fragile and vulnerable to shocks as a result of the lack of new capital sources and inherited non-performing loans (Várhegy 1993). Furthermore, the lack of competition in the banking sector, due to specialisation of financial institutions, impeded much-needed reforms of the financial sector thus limiting enterprises' access to competitive finance.

Despite these negative conditions at the outset, Hungary is today considered by some to be one of the more successful reforming economies in the region (EBRD 1997, Halpern and Wyplosz 1998). Table 5.1. shows that, despite the initial declines, GDP and industrial output have recovered and are likely to reach 1989 levels in the near future. Leaving aside statistical problems, these figures have to be interpreted cautiously. Firstly, the economic decline was well underway before 1989 and therefore, whilst 1989 is generally used as indicating the start of transition, it is perhaps a less useful measure in gauging the recovery of the economy. Furthermore, the transition economies, Hungary included, are starting growth from a low level of national income and thus there is a base effect distorting the picture. Lastly, as Haynes (1996) points out, the transition economies are *de facto* chasing a moving target since, even as they reach 1989

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[3] Székely and Newbery (1993) estimate production and export subsidies at around 13 percent of GDP in 1989.

[4] The Hungarian industries with highest negative value-added include meat, fish and dairy products; fruit and vegetable products, oils and fats and iron and steel (Hare and Hughes 1992). Except for the last, iron and steel, whose uncompetitiveness can be explained in terms of lack of natural advantages, the other sectors represent industries typically characterised by the presence of small and medium enterprises in market-type economies, the absence of which, in Hungary, will be analysed in greater detail later in this chapter.

levels, the world economy will have moved on. Thus, whilst the figures point towards a good performance in comparison with other transition economies, Hungary is still trying to catch up with incomes of even the poorest European Union countries (Myant 1997).

Table 5.1: Selected economic indicators for Hungary

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 * | 1997 ** |
|---|---|---|---|---|---|---|---|---|
| **Output and Expenditure, national accounts at constant prices (% change)** | | | | | | | | |
| GDP | -3.5 | -11.9 | -3.1 | -0.6 | 2.9 | 1.5 | 0.5 | 2.5 |
| Private consumption | -3.6 | -5.6 | 0.0 | 1.9 | -0.2 | -4.5 | 3 | na |
| Public consumption | 2.6 | -2.7 | 4.9 | 27.5 | -12.7 | -6 | 6 | na |
| Gross fixed investment | -7.1 | -10.4 | -2.6 | 2.0 | 12.5 | 1 | 4 | na |
| Industrial gross output | -9.3 | -18.4 | -9.7 | 4.0 | 9.6 | 4.8 | 2 | na |
| **Prices and wages (% change)** | | | | | | | | |
| Consumer prices (annual average) | 28.9 | 35.0 | 23.0 | 22.5 | 18.8 | 28.2 | 23.7 | 19 |
| Producer prices (annual average) | 21.8 | 32.7 | 10.7 | 11.0 | 11.3 | 28.9 | 21.8 | 19 |
| **Monetary sector (% change)** | | | | | | | | |
| Broad money (end year) | 29.2 | 29.4 | 27.3 | 17.2 | 13.0 | 18.5 | 23 | na |
| **Government sector (% of GDP)** | | | | | | | | |
| General government balance | 0.4 | -2.2 | -5.5 | -6.8 | -8.2 | -6.5 | -3.5 | -4 |
| General government expenditure | 53.5 | 54.3 | 61.6 | 62.2 | 62.1 | 56.1 | 50.5 | na |
| General government debt | na | 75.4 | 79.4 | 90.2 | 87.7 | 85 | 78 | na |
| **External data in convertible currencies (billion US $)** | | | | | | | | |
| Current account | 0.1 | 0.3 | 0.3 | -3.5 | -3.9 | -2.5 | -1.7 | na |
| Trade balance | 0.3 | 0.2 | 0.0 | -3.2 | -3.6 | -2.4 | -2.7 | na |
| External debt, net of reserves | 20.2 | 18.7 | 17.1 | 17.9 | 21.8 | 19.6 | 17 | na |
| FDI (BOP data) | 0.3 | 1.5 | 1.5 | 2.3 | 1.1 | 4.5 | 1.9 | na |
| **Memorandum items** | | | | | | | | |
| Employment (% change, end year) | -3.1 | -9.6 | -9.3 | -5.0 | -2.2 | -1.4 | -5.6 | na |
| Unemployment (% of labour force) | 1.9 | 7.5 | 12.3 | 12.1 | 10.4 | 10.4 | 10.5 | na |

*estimate

**projection

Source: European Bank for Reconstruction and Development 1997

A positive trend has been in respect of government finances where the total government debt as well as the budget deficit have been declining as a result of the austerity measures implemented by the Horn Government. However, the government deficit remains a potential source of instability. The most remarkable progress perhaps has been achieved in the external field. Hungary has, in per capita terms, been the highest recipient of foreign direct investment (FDI) in the region, with substantial effects both at

the macrolevel in BoP terms, and at the microlevel in respect of technology transfer (Barta 1993, Meyer 1998). Hungarian foreign trade has also seen significant reorientations, with the European Union countries accounting, at the end of 1996, for 60 percent of imports and 63 percent of exports (NBH 1997). The relative lack of competitiveness and unfavourable terms of trade[5], however, caused the overall trade balance to remain negative. Nevertheless, the improved export performance, helped by devaluations via the crawling peg exchange rate regime, has been instrumental in the revival of the performance of the industrial sector (Blaho and Gál 1997).

Despite these positive factors, there remain a number of issues for concern. Inflation is forecast to remain at a high level of 10 percent in 1999 (*The Economist*, 6th November 1999) even though, following the monetarist view of reformers and foreign advisors, austerity measures and prudent monetary policies have been employed to curb excess demand. However, some analysts (Lavigne 1999) have argued that the *continuing* inflation is strongly influenced by supply-side factors including increases of energy prices to world market levels (following the discontinuation of cheap energy supplies in the wake of the collapse of the CMEA), price increases of imported goods (due to devaluations of the *forint*) and finally, rising financial costs, namely high interest rates. Thus, excessive austerity measures and high real interest rates can be viewed as contributing not only to drops in real incomes and depression of investment but also to persisting inflationary pressures in the economy. The second macroeconomic policy concern is related to the level of external debt which at a forecasted level of 60.6 percent of GDP in 1999 is the highest of the first-wave EU entrants (*The Economist*, 6th November 1999) and which continues to be a key determinant of economic policy-making. Unemployment, though slightly below the European Union average and

[5] Despite the conclusion of the Europe Agreement with the European Union which envisaged an asymmetric dismantling of trade barriers, Hungary has been disadvantaged insofar as original levels of tariffs were higher on the European Union side, leaving Hungary relatively less protected. Furthermore, the high share of sensitive goods in Hungarian - EU trade and their coverage by separate protocols led to further restrictions in market access (Lavigne 1999). However, some forms of FDI, in particular joint ventures, have eased market access and the forthcoming accession as dealt with in the Agenda 2000 is likely to lower the remaining trade obstacles.

stagnating, is high at 10.5 percent, particularly when taking into account the significant spatial variations in unemployment levels.[6] Accession to the European Union, whilst promising benefits in the long run, is likely to impose significant short-term costs especially in regards to compliance with the acquis, thus further straining an already precarious budgetary situation.

However, whilst the macroeconomic indicators are at best ambivalent, Hungary has achieved substantial progress in reforms at the micro-level, laying much of the necessary institutional framework for a long-term sustainable recovery. Achievements at the micro-level include the already mentioned restructuring effect through FDI, the most deep-seated banking reforms in the region (Halpern and Wyplosz 1998), a comprehensive overhaul of the tax and social insurance system and a pragmatic and market-oriented privatisation programme (Inzelt 1994, EBRD 1997). Halpern and Wyplosz (1998) have argued that the concern with the much-needed, albeit slow, microeconomic reforms, coupled with the 1995 austerity measures, have slowed Hungary's recovery during the transition, yet places it in a strong position to continue sustainable growth. The development of small firms can be viewed as another indicator of reallocation and restructuring at the micro-level and this will be returned to in section 5.3.. Whilst the Hungarian experience has been one of slow and steady transition, the Russian Federation has experienced a much more turbulent reform process. The following section seeks to chart the Russian transitional path.

## 5.2. Russian economic transition - too much shock, too little therapy?

The decline of the Soviet Union has surprised many observers not only in respect of the speed with which it occurred but more important with regard to the scale and the scope of the reported contraction.[7] In the view of Russian reformers and Western advisors

[6] See chapter 7 for more detailed information on regional economic differences.
[7] For a summary on the shortcomings of official Russian statistics see Birman (1996) and Voronkov (1998).

alike, the rapid unleashing of market forces, combined with prudent monetary and fiscal policies, would soon restore equilibrium conditions and provide the basis for sustained income growth (Chernomyrdin 1994, Granville 1995, Layard and Parker 1996). Yet such optimism was based on abstract theoretical models, dubious assumptions and a lack of appreciation of the specificities of the Russian case. In particular, reformers underestimated the legacy of over six decades of central planning. The results of hastily applied shock therapy measures in an environment characterised not only by severe macroeconomic disequilibrium but also by absent or dysfunctional institutions were nothing short of disastrous (Hedlund 1999) and were then exacerbated by subsequent attempts to prevent a worsening of the situation through ad hoc policy intervention.

Table 5.2: Selected economic indicators for Russia

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 * | 1997 ** |
|---|---|---|---|---|---|---|---|---|
| **Output and expenditure (% change)** | | | | | | | | |
| Real GDP | na | -13.0 | -14.5 | -8.7 | -12.6 | -4.0 | -6 | 1.5 |
| Investment at constant prices | 0.1 | -15.0 | -40.0 | -12.0 | -26.0 | -13.0 | -18.0 | na |
| Industrial production | -0.1 | -8.0 | -18.8 | -16.2 | -22.8 | -4.7 | -5.0 | na |
| **Prices and wages (% change)** | | | | | | | | |
| Consumer prices (annual average) | 5.6 | 92.7 | 1354 | 896 | 302 | 190 | 48 | 20 |
| Wages (annual average) | 15.2 | 80.1 | 994 | 879 | 272 | 124 | na | na |
| **Monetary sector (% change)** | | | | | | | | |
| Net domestic assets | na | na | na | 770 | 360 | 70 | 81 | na |
| Broad money (end period) | 17.6 | 126 | 643 | 409 | 200 | 126 | 34 | na |
| **Government sector (% of GDP)** | | | | | | | | |
| General government balance (cash basis) | na | -31.0 | -18.8 | -7.6 | -10.1 | -4.9 | -7.7 | na |
| **External data (billion US dollars)** | | | | | | | | |
| Current account balance vis-à-vis non-CIS countries | na | 3.5 | -5.7 | 2.3 | 1.2 | 5.7 | 9 | na |
| Trade balance vis-à-vis non-CIS countries | na | 8.1 | 4.4 | 11.9 | 14.3 | 18.1 | 19 | na |
| **Memorandum items** | | | | | | | | |
| Open unemployment (in percent of labour force, end year) | na | na | na | 5.5 | 7.1 | 8.2 | 9.3 | na |

*estimate,
**projection
Source: European Bank for Reconstruction and Development 1997

The following points serve to summarise the current economic dilemma:

Official GDP has declined by 43 per cent compared to 1989 levels.[8] Although there have been signs of a bottoming-out of the situation in late 1997, the meagre growth achieved provides little cause for optimism.[9] Even if Russia were able to rapidly accelerate growth, it would take up to the year 2008 at growth rates of 5 percent per annum (a pretty heroic assumption given current difficulties) to reach 1989 levels of national income again. At a per capita GNP of US$ 2,650 in 1994, Russia ranked among lower middle income economies such as Panama, Venezuela and Botswana.

Transition in Russia has brought about an increasingly skewed income distribution with "...incomes now less equally distributed in Russia than they are in America" (*The Economist*, 29th April 1995). Birman (1996) argues that the use of Gini coefficients "...is one more example of the (mis)use of Western economics tools as universal..." and that the scale of income disparity is better illustrated by the change in the relationship of the incomes of the wealthiest 10 per cent of population over the poorest 10 per cent from 4.5 times in 1991 to 15 times greater in 1994. Morvant (1996) using Goskomstat data estimates that, in the first quarter of 1995, 45.1 million people, or 30 percent of the total population, had incomes below minimum subsistence levels. Whatever measure one choses to look at, transition Russian-style is undoubtedly associated with the increasing fortunes of a few whilst worsening the lot of the many.

The steep decline in production has not been matched by a corresponding explosion of officially recorded unemployment, leading some observers to argue that "...unemployment has proven to be the least of Russia's problems in its transition to capitalism" (Aslund, 1996, p.12). Yet the official statistics on which such statements are based are notoriously unreliable (Aukutsionek and Kapelyushnikov 1994). Furthermore, such an assessment is based on standard assumptions of what constitutes unemployment and reflects a lack of insight into the often non-standard and unpredictable behaviour of

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[8] Over the period 1991-1997 the losses in Russian national wealth are estimated at around US$1.2 trillion, three times more than those experienced in the Second World War (Sementsov 1998).
[9] Indeed, the crisis in August 1998 set back any hopes of a recovery in GDP in that year.

Russian enterprises and indeed the Soviet legacy of underemployment. Morvant (1995) and Morvant and Rutland (1996) argue that the low level of officially registered unemployment, in addition to statistical shortcomings, is a function of the lack of hard budget constraints and the perseverance of paternalistic practices by enterprises. Thus, the decline in output is accompanied by rising unemployment although partially disguised by 'hidden unemployment'.

Macroeconomic stabilisation, one of the cornerstones of reform measures, is still precarious. Inflation has fallen from a peak of 2,501 per cent in 1992 to 10 per cent in 1997, but inflationary pressures remain high due to the persistence of budget deficits fuelled by the inability of reformers to meet revenue targets. The inflationary impact of the budget deficit has been cushioned by resorting to debt financing through government securities and loans from international institutions. This is, however, only a short-term solution since, in the future, debt-servicing will create additional pressures[10] and some of the sources will dry up altogether. Attempts to narrow the budget deficit have been thwarted by the inability of the government to push through a new tax code, to meet revenue targets and to refrain from the continued subsidisation of enterprises. Thus, macroeconomic stability is only short-term[11] and remains volatile.

Composition of GDP by end use has undergone significant alterations, signalling a necessary change in the pattern of resource allocation (Hanson 1996). However, the steep decline in investments[12] gives rise to concerns about the long-term ability of Russian enterprises to compete. The strong export performance of the primary sectors,

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[10] The monetarist arithmetic was severely put to the test in the summer of 1998 as central bankers tried to stem the tide of fleeing investors through quintupling of interest rates, putting additional pressures for debt servicing costs on an already beleaguered budget and finally defaulting on large parts of rouble-denominated debt. In the first half of 1999, there has been considerable speculation as to whether Russia will be able to meet its international debt obligations (see *The Economist* and *Financial Times*, several issues).

[11] In summer 1998, the government had to abandon its last plank of stabilisation and devalue the rouble, a measure accompanied by a default on its short-term rouble denominated debt amid the spectre of a collapsing financial system.

[12] The volume of capital investment is reported to have declined by 92 percent (Sementsov 1998).

in particular oil and gas, has not been unproblematic either as it gave rise to the so-called 'Dutch disease' (Hare et al. 1996).[13] Furthermore, the decline in world market oil prices in 1998 dented the current account surplus and increased budgetary pressures due to the reliance on oil revenues.

Despite a potentially huge market, abundant sources of raw materials and low labour costs, Russia has thus far attracted only a minute share of the relatively small inflows of Western Foreign Direct Investment (FDI) into Central and Eastern Europe (EBRD 1997, Meyer and Pind 1999). This lack of attractiveness of the Russian economy for foreign investors is largely a function of the prevalence of investment disincentives ranging from legal and financial disincentives to economic volatility and hence high risk. Moreover, the inflows of foreign capital are dwarfed by capital flight from Russia (Tikhomirov 1997) as wealthy Russians are seeking to safeguard their gains from a volatile economy. However, even if FDI inflows were to increase drastically, there is little convincing theoretical or empirical evidence to suggest that it would have a significant restructuring effect (Hardy and Rainnie 1996).

Privatisation, although proceeding rapidly, has significantly entrenched insider-control and strengthened the hand of the industrial-financial elites (Chance 1999). Aside from some exceptions (see for example Hendley 1998), the evidence points to the limited pursuit of 'shallow restructuring' only (Earle et al. 1995, Filatotchev et al. 1999). The formation of Financial-Industrial Groups (FIGs) can be viewed as evidence of the entrenchment of corporatist-corrupt structures which resist the imposition of hard budget constraints, stifle competition and form ever more powerful industrial lobbies (Starodubrovskaya 1995, Freinkman 1995).

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[13] 'Dutch disease' is a term used to describe a phenomenon of exchange rate appreciation as a result of balance of trade surpluses accruing from raw material exports, resulting in a loss of competitiveness of other sectors in the economy.

Russian science, once among the best developed and funded sectors, is starved of resources as the budgetary situation tightens and is affected by the 'brain-drain'.[14] Kuznetsov (1995) compares the current state of Russian R&D with that of Argentina in the 1970 at the beginning of economic development.

The preceding analysis sketched a broad outline of the precariousness of the Russian situation following economic reforms. As the *Financial Times* (1992) noted, there is much evidence of a shock but little in the way of therapy. The destruction wrought by decades of Soviet economic mismanagement and early economic reforms of the shock-therapy type have hardly succeeded in creating a seedbed from which we can reasonably expect future growth to emanate. Ironically, by 1994, this view was already shared by one of the architects of Russian reforms, Jeffrey Sachs, who argued that "Russia is in a state of deep crisis that could send the country into a spiral of self-reinforcing destructive behaviours: criminality, regional separatism, tax evasion, and flight from the currency" (Sachs (1994) as quoted in Hedlund and Sundström, 1996, p.911). The crisis of 1998 in Russia was indeed a manifestation of these features. Thus, the Russian Federation is fundamentally different as a 'transition' economy compared to Hungary, not only in respect of levels of national income and growth but also with regards to the establishment of the basic framework of democracy and that of a market-type economy. Given these developmental differences, one would also expect different trends in the development of small firms in the two countries, with Hungary starting to approximate size structures observed in European Union countries and with Russia continuing to exhibit distortions. The following two sections will take a closer look at the evolution, structure and role of small firms in the two countries.

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[14] Approximately 800,000 highly skilled professionals are estimated to have left the country since 1991 (Sementsov 1998).

## 5.3. Small firm development in Hungary

### 5.3.1. Antecedents - the development of small firms in the second economy

The Hungarian economy during the socialist period exhibited many of the structural problems of centrally-planned economies, including distortions in size class distribution. However, unlike other economies in the region, Hungary embarked relatively early upon a series of economic reforms aimed mainly at easing the rigidities and thus alleviating some of the inefficiencies, both static and dynamic, of central planning.

The first wave of reforms started in 1968 with the implementation of the New Economic Mechanism (NEM), a series of reforms that abolished direct central planning targets and gave enterprise managers greater autonomy over decision-making processes. In the foreign trade area, isolation from international markets was gradually lessened. Monetary and fiscal policy instruments attained greater relative importance in steering the economy as direct planning gradually diminished in importance. Hand in hand with the moves towards greater decentralisation and partial liberalisation of the external sphere went a more liberal stance towards private and semi-private activities in 'shortage sectors', especially craft enterprises and agriculture (Hoggett and Kállay 1993, Kállay 1993). The main thrust of reforms, however, focused on the public sector, where new small firms were starting to emerge as previously centralised entry and exit criteria were abolished in favour of a more indirect steering approach that delegated much of the strategic responsibility on entry and exit to the level of the (state-owned) enterprises. Thus, small firm development during that period can be viewed as flowing from a recognition by policy-makers of the need for greater decentralisation and of the role of small firms as a vehicle to overcome supply-side constraints associated with rigid planning and centralisation of economic activity in large firms, thus paving the way to the Hungarian variant of 'market socialism'. As Blaho and Gál (1997) note, liberalisation

under the NEM, in both the domestic and foreign trade arena, went a long way in improving living standards and helped to avoid some of the disequilibria, such as hidden inflation and chronic shortages that were experienced in many economies in the rest of the region.[15] However, as Woods (1988) notes, concentration in the economy during that period failed to decrease and the resulting new structures relied heavily on redistribution of profits to continue operations. According to Woods (1988), rather than the emergence of genuine 'market socialism', we witnessed the development of 'consensus management' based on the internalisation, by large state-owned enterprises, of "central outlook" which perpetuated inefficiencies and ultimately contributed to economic slowdown in the late 1970s.[16]

Table 5.3: The development of national income in Hungary 1950-1980 (1950=100)

| | |
|---|---|
| 1950 | 100 |
| 1955 | 132 |
| 1960 | 177 |
| 1965 | 216 |
| 1970 | 300 |
| 1975 | 406 |
| 1980 | 476 |

Source: Hungarian Statistical Yearbook 1981, as quoted in Berend and Ranki 1985

The second wave of reforms in the 1980s sought to address the problem associated with large firm dominance in the economy through a more comprehensive liberalisation of small firm sector activity. The 1980s reforms differed from the preceding ones under the NEM insofar as policy-makers recognised the importance of tackling decentralisation in conjunction with ownership issues. The divorce of the two had led to responses from the

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[15] One of the less positive effects of the policies born under the NEM was the growing external indebtedness of Hungary, a legacy that today continues to affect macroeconomic policies.

[16] In addition to internal factors, the deteriorating economic situation in Western Europe and the rest of the world also affected the Hungarian economy adversely as Hungary was much more open to world economic developments and was as a resource-poor economy particularly susceptible to the supply-side shocks of the 1970s (Roman 1989).

entrenched interests of the state-owned enterprises that were inadequate in addressing their fundamental inefficiencies. The experience in the agricultural sector, with work performed in addition to regular employment in state-owned and co-operative farms, served as an example worthy of emulation in the inefficiency-plagued industrial sector (Szita 1987). Thus, a variety of new (small) business forms emerged which were either functioning as legal entities (small co-operatives for example), were tied to legal entities (enterprise business work partnership) or were organisations established by private persons (civil law associations).[17] The most numerous of those were Enterprise Business Work Partnerships (VGMK according to the Hungarian abbreviation) (Laky 1985) which were set up by workers or retired workers[18] using the assets of an enterprise for a fee paid to the founding firm with liability limited to the financial contribution and income earned in the business (Laky 1984) [the former was mostly symbolic as most assets were provided by the enterprise within which the VGMK operated (Szita 1987)]. Thus, the emerging small firm sector should be viewed as forming the backbone of the so-called 'second economy', that is, entrepreneurial activity performed neither in the dominant state-owned sector nor illegally in the black economy but in addition to jobs held in the formal, first economy (Berend and Ranki 1985).

The expectations associated with the freeing of small enterprise activities in the second economy were great. In particular, policy-makers sought to increase the standard of living as smaller and hence more flexible units would be able to cater for products and services that larger units would typically be unable to supply (Laky 1984). Thus, shortages both in terms of goods, services and labour that accrued as a result of the suboptimal performance of the first economy would be alleviated. Superfluous labour in the state-owned sector, particularly semi-skilled and unskilled, would be more profitably employed (Varga 1988). The smaller units, uncushioned by the soft budget constraint that larger enterprises faced would be more exposed to market forces and

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[17] For a more detailed description see Szita (1987) and Laky (1984).

[18] The hiring of outside labour is, unlike in the case of Civil Law Partnerships (PJT) or Business Partnership (GMK), prohibited in this form of venture (Laky 1984).

hence operate more efficiently in their goal of profit maximisation (Woods 1988). The additional incomes earned were envisaged to be an important component of investment into production rather than being spent on wasteful consumption (Laky 1984, Varga 1988). Lastly, the forging of closer linkages between small and large firms in the context of the Enterprise Business Work Partnerships was seen as a means to improve the performance of the large firm sector as the smaller units would be able to provide vital supplies to the large firms, thus easing bottlenecks and shortages in the large firm sector (Laky 1984).[19]

The actual performance of the small enterprise sector that emerged as a result of the 1980s reforms was, however, less spectacular, and did not prove to be a panacea to the ailing Hungarian economy.

Table 5.4: Industrial activities in Hungary by type of organisation in 1987

| Type of Organisation | Number of enterprises or other units | Employment (thousand) | Percentage share in the value of total industrial output |
|---|---|---|---|
| State-owned enterprises | 1043 | 1258 | 80.3 |
| Industrial co-operatives | 1392 | 196 | 6.1 |
| Working communities and groups | 12484 | 193 | 0.6 |
| Private industry | 47691 | 81 | 1.8 |
| Non-industrial organisations | 2492 | 218 | 11.2 |
| Total | - | - | 100 |

Source: Roman 1989, p.305

Table 5.4. illustrates that despite an increase in the numbers of small enterprises, the large state-owned enterprise sector remained dominant in terms of manufacturing output, accounting for over 80 per cent of the total value of manufacturing output. Concentration, measured in terms of share of employment, was equally high, with only

[19] It was not, however, envisaged, that the small units would improve large firm efficiency through competitive pressures. Indeed, as Szita (1987) notes, the VGMKs were able to operate in any areas as long as they did not infringe a state monopoly.

the United States and Great Britain exhibiting a level of concentration close to that of Hungary in the 1980s (Roman 1989). Furthermore, the small enterprises that emerged during the period tended to be very small, with both capital[20] and employment minimal and with no intention of being increased (Laky 1989), and thus unlikely to challenge the supremacy of large-scale organisations. Although Kovacs (1986) argues that the growth of small enterprises with the *capacity* to create employment is more important than actual job creation, others questioned the fundamental ability of the small units to create more than 'part-time' employment in the prevailing economic climate (Laky 1984 and 1989). Thus, the new enterprise forms were viewed by some observers not as genuinely new economic activities but rather as some form of work brigade substituting for large enterprise needs for overtime work (Laky 1985). This view is supported by Gabor (1994) who argues that the growth of new small ventures was coupled with a decline in full-time participation in the second economy, in other words, employment in the second economy only appeared attractive and feasible when coupled with continuing employment in the first economy. As for the role of small firms in helping to overcome shortages, expectations were not fulfilled, as the strong ties between small firms and the large firm sector weakened the market sensitivity of small ventures and subsequently provided little incentive to eradicate shortage situations (Varga 1988).

The emergence of the second economy in Hungary, as a result of reforms which partially liberalised the small firm sector, did not, despite the growth of new small ventures, thus lead to a significant alteration of the distorted size structure of the economy and an erosion of the predominance of large scale firms, nor in fundamental changes in the behaviour of economic agents. As figure 4.1. illustrates (see previous chapter), the Hungarian economy, in terms of size distribution, was characterised by an inverted pyramid, that is to say, the size structure of market-economies turned upside

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[20] Varga (1988) points to the relative lack of investment of personal savings in the small firm sector as a result of uncertainty in economic decision-making by the government and the prevailing ideological hostility towards income generating activities. The logical outcome was the preservation of handicraft-type character of small firm activity which favoured quick enrichment over long-term systematic capital accumulation.

down, a feature prevalent in many of the economies of the region (Newbery and Kattuman 1992).

As some economists suggest (Laky 1989), the reforms that liberalised the private and semi-private sector were insufficient to stimulate a large-scale expansion of the small firm sector to a degree that would in any way have challenged the supremacy of the large firm public sector. What we did see, however, was the emergence of a dual economy characterised by the parallel existence of both large firms in the state sector and small, private and semi-private ventures which were parasitic on the public sector. This dualism, however, neither improved the efficiency of the large firm sector nor did it lead to the emergence of efficient small-scale producers, as the latter owed their existence as much to their ability to earn extra income in the second economy as to their relatively sheltered life in the shadows of the inefficient first economy (Neumann 1993).[21] Gabor (1994) suggests that such entrepreneurs are ill-equipped to face even limited competition and are thus likely to resist any attempts at marketisation, as their very survival is dependent upon the maintenance of the status quo. Thus, only reforms of a systemic character, tackling not only the liberalisation of small firm sector activity but also the marketisation of the large firm sector and also tackling a fundamental reform in the way in which enterprises, both large and small, interact, are likely to break the destructive dualism and open the way for new constructive forms of interaction.

[21] A sociological survey of entrepreneurs carried out by Kuczi and Vajda (1990) suggests that the most common complaints of Hungarian entrepreneurs were associated in some way or other with 'shortages' whereas competition was not seen as influencing the business in any way. The finding implies that Hungarian entrepreneurs of the 1980s were not exposed to competition either from the state-owned sector or the other small-scale units.

### 5.3.2. The Hungarian small firm[22] sector in transition

The growth in the numbers of Hungarian small firms following liberalisation has been explosive. Table 5.5. highlights the trends with a twenty fold increase in the numbers of enterprises with less than 20 employees.[23] Medium-sized firms also exhibit an increase in numbers but less spectacularly than small firms. As might be expected, given high concentration ratios at the outset of reforms, the only category of enterprises declining in numbers is large firms, exhibiting a drop of 44 percent in numbers between 1989 and 1995.

Table 5.5: Number of institutions with legal status by staff categories in Hungary

| | less than 11 persons | 11-20 persons | 21 to 50 persons | 51 to 300 persons | more than 300 persons | Total |
|---|---|---|---|---|---|---|
| 1989 | na | 5,105* | 2,387 | 3,459 | 2,617 | 13,568 |
| 1990 | na | 16,465* | 4,129 | 4,469 | 2,599 | 27,662 |
| 1991 | na | 36,809* | 6,169 | 5,372 | 2,396 | 50,746 |
| 1992 | na | 52,825* | 6,970 | 5,773 | 1,937 | 67,505 |
| 1993 | 39,772 | 28,447 | 7,637 | 6,055 | 1,624 | 83,535 |
| 1994 | 57,752 | 25,784 | 8,041 | 6,127 | 1,340 | 99,044 |
| 1995 | 87,885 | 14,044 | 8,249 | 5,598 | 1,152 | 116,928 |

*including institutions employing less than 11 persons
Source: KSH 1994 and 1995

When taking into account institutions with non-legal status such as partnerships and sole proprietors, which are more typically representative of the small firm sector, the weight of small firms in the Hungarian economy becomes more evident.

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[22] No uniformly accepted definition of small firms has been developed in Hungary and various governmental and non-governmental institutions use their own definitions (Futo 1997). The most commonly used one defines microenterprises as having less than 10 employees, small ones as having between 10 and 50 employees and medium ones between 50 and 300 employees (interview L. Kallay 1993 and 1997).

[23] These data should be interpreted with caution due to shortcomings in the statistical collection, especially in the early years of the transition period and the difficulties associated with statistics on the small firm sector in terms of reporting requirements and compliance with those. In recent years, the Hungarian Central Statistical Office (KSH) has expanded its collection of data on small firms distinguishing for example between active (operational) enterprises and registered enterprises. However, due to the associated changes in methodology, time series comparisons are fraught with additional difficulties.

Table 5.6: Enterprise distribution by employee category in Hungary, End 1995

| | less than 11 | 11-20 | 21-50 | 51-300 | 300+ | Total |
|---|---|---|---|---|---|---|
| **Legal Entities of which:** | 87,885 | 14,044 | 8,249 | 5,598 | 1,152 | 116,928 |
| **Private limited co.** | 81,398 | 11,693 | 6266 | 3,007 | 333 | 102,697 |
| **Public limited co.** | 1,054 | 253 | 439 | 804 | 636 | 3,186 |
| **Cooperative** | 3,809 | 1,544 | 1,329 | 1,542 | 97 | 8,321 |
| **Non-legal entities of which:** | 926,128 | 2,314 | 935 | 214 | 20 | 929,611 |
| **Limited Partnership** | 101,362 | 824 | 304 | 66 | 4 | 102,560 |
| **Sole Proprietor** | 789,951 | 1,017 | 405 | 107 | 16 | 791,496 |
| **Total Enterprises** | 1,014,013 | 16,358 | 9,184 | 5,812 | 1,172 | 1,046,539 |

Source: KSH 1995

Table 5.6. indicates that, by the end of 1995, almost 98 percent of Hungarian businesses were microenterprises and 0.1 percent large firms, with the remaining two percent constituting small and medium-sized firms. Furthermore, the most prominent form of business was sole proprietorships constituting around three quarters of all firms, followed by limited liability companies which accounted for around 12 percent of businesses. Both categories, however, are typified by the predominance of small and very small units.

The figures therefore suggest that the inverted pyramid size structure typical of the socialist period has been fundamentally changed and that microenterprises under sole proprietorship constitute the most numerous form of business in the Hungarian economy. However, as Schifner and Hamori (1997) note, this predominance of microenterprises signals increased polarisation of the Hungarian economy: in contrast to European Union countries, Hungary lacks a stable small and medium enterprise sector.

Table 5.7: Structure of the number of enterprises by company size in the EU and Hungary, 1996

| | very small | small | medium | large | total |
|---|---|---|---|---|---|
| number in EU (1,000) | 17,285 | 1,105 | 165 | 35 | 18,590 |
| structure in EU (%) | 92.98 | 5.94 | 0.89 | 0.19 | 100.00 |
| number in Hungary (1,000) | 619 | 15 | 4.4 | 0.6 | 639 |
| structure in Hungary (%) | 96.87 | 2.35 | 0.69 | 0.09 | 100.00 |

Source: The Hungarian Economy, 1999, p.6

This suggests that although entry restrictions have been eased, resulting in new mass entry, there are pervasive forces at work that stymie the growth of these micro units into small and medium firms. Gabor (1997) argues that both internal and external factors account for this lack of growth dynamics of microenterprises. Internally, factors such as the consumption orientation of households, risk averseness and short-termism of entrepreneurs, preference for income maximisation at the expense of leisure time, undemanding full-time employment and a low tax morale are typically leading to the setting up of small ventures that enable the entrepreneurs to earn extra income with little risk (Gabor 1997, Czako and Vajda 1993, Futo and Kállay 1994). Externally, transformation-typical pressures such as unemployment and declining real wages (Czako and Vajda 1993) combine with government propaganda to encourage people into entrepreneurship even though they might be ill-equipped for such undertakings due to their lack of relevant experience (Hann and Laki 1992, Gabor 1997). Furthermore, Gabor (1997) points to the severance of ties between large firms and small undertakings as large firms themselves are threatened by transition-typical constraints as another factor encouraging the proliferation and fragmentation of firms.

Another striking feature of the Hungarian small firm sector is the nature of employment in small firms. Looking at the category of sole proprietors, in 1996, for only 56 percent of sole proprietors did self-employment constitute their main occupation. For 33 percent, self-employment was a secondary occupation and 10 percent were retired people seeking to supplement their income (KSH 1997). Furthermore, the latter category has shown the highest growth, increasing by 25 percent between 1995 and 1996, whereas the number of sole proprietorships in total only increased by 10 percent and self-employment as main occupation category by 9 percent during the period 1995-96. Various explanations can be advanced. A survey by Czako and Vajda (1993) purports that entrepreneurs which were 'pulled'[24] into the small-firm sector frequently exploited business opportunities with the security of a another job, often in the state-owned sector, as a back-up. This strategy enabled them to limit the risk associated with becoming a full-time entrepreneur. The survey also suggests that a high proportion of entrepreneurs (almost a third) went into business in order to maintain their standard of living, as real incomes, in particular in the state sector, have been declining. This motive was especially prevalent for self-employed retired people of whom almost half felt that they needed to augment their meagre pensions with incomes in the private sector (Futo and Kállay 1994). In addition to the above outlined push and pull factors, the high proportion of self-employed, for whom business is not their primary occupation, can be viewed as a legacy of the second economy, where the necessity to top-up declining state-sector wages through second and third jobs became a way of life. The continuing rigidity in the Hungarian labour market with diminished potential for overtime is another factor encouraging people to seek secondary employment in the small firm sector which often absorbs redundant labour in sweatshop conditions (Gabor 1997).

[24] 'Pull' factors relate to a theory seeking to explain new firm entry. Within this framework, new entrepreneurs are entering business in response to the possibility of higher incomes generated from these ventures compared to convential wage employment (Bartlett and Hoggett 1994, Storey and Johnson 1987).

In addition to size, legal categories and job status, sectoral distribution is another key feature of the Hungarian small firm sector. To gain an insight into the sectoral distribution of Hungarian small business, it is useful to consider the distribution of sole proprietorships.[25]

Table 5.8: Sectoral distribution of active sole proprietorships (by legal category) in Hungary in 1996

| | Liberal Profession | Artisans | Retailers | Agricultural Individuals | Total |
|---|---|---|---|---|---|
| Agriculture, hunting, forestry and fishing | 2,561 | - | - | 20,121 | 22,682 |
| Mining and Quarrying | - | 27 | - | - | 27 |
| Manufacturing | - | 55,953 | - | - | 55,953 |
| Construction | - | 39,876 | - | - | 39,876 |
| Wholesale and retail trade, repair of motor vehicles, motorcycles and personal and household goods | - | 12,826 | 125,772 | - | 138,598 |
| Hotels and restaurants | - | - | 25,534 | - | 25,534 |
| Transport, storage and communication | - | 37,992 | 57 | - | 38,049 |
| Financial intermediation | 1 | - | - | - | 1 |
| Real estate, renting and business activities | 91,185 | 5,730 | 2,262 | - | 99,177 |
| Education | 1 | - | - | - | 1 |
| Health and social work | 6,063 | - | - | - | 6,063 |
| Other community, social and personal service activities | 3,888 | 29,768 | 546 | - | 34,202 |

Source: KSH 1997

Table 5.8. highlights the very uneven sectoral distribution[26] of the small firm sector. Wholesale and retail trade and repairs account for 30 percent of small business activity, followed by real estate with 21 percent. Manufacturing small firms are relatively underrepresented, accounting for only 12 percent of sole proprietorships. A different

[25] Only 0.01 percent of sole proprietorships fall into the 51-300 employment category - the vast majority are employing less than 11 people.

[26] These figures have to be interpreted with caution as one of the typical features of small businesses in transition economies is their simultaneous engagement in a number of activities. Thus, official statistics might show a bias towards manufacturing as this is the most visible component of enterprises' activities.

picture emerges when looking at the sectoral distribution of limited companies, the second most numerous category of small firms. Here 17 percent of limited liability companies are engaged in manufacturing activities, above the average for all active businesses in Hungary of 13 percent, and 37 percent of trade and repair activities (KSH 1997).

A number of interesting issues arise from the above. Firstly, the small firm sector appears to be instrumental in altering the sectoral balance of the economy. When looking at the composition of GDP, services accounted for 60 percent of GDP in 1994 compared to 30 percent in 1980. Thus the growth of the small firm sector coincides with a shift in the structure of the economy towards service-based activities, a trend that is typical of economic development in the advanced market economies over recent years. In manufacturing, small firms, in particular microenterprises under sole proprietorship, are underrepresented. This trend towards the development of relatively shallow small firm activity and the lack of a critical mass of small firms in manufacturing is typical of small firm development in the transition economies (see chapter 4). It is a reflection of not only structural changes in the economy but also a relatively hostile external environment for manufacturing. Unfavourable environmental conditions, such as high inflationary tendencies, restricted domestic demand due to stringent monetary policies, an uncertain legislative environment and under-developed capital markets encouraged entrepreneurs to operate in sectors where minimum capital is required and where quick (and possibly invisible) profits can be made (Gabor 1997). Thus, the predominance of trade and service sector activities of small firms should be viewed in the context not only of (positive) structural changes but also of pervasive market imperfections and failures.

Given the fragility of Hungarian small firms, from the point of view of size and composition, we would expect a relatively high turnover of firms. Yet, the statistical evidence points to a relatively low failure rate, at least of legal forms of enterprises.

Table 5.9: Establishment and liquidation of enterprises with legal status in Hungary

| Year | Establishments | Liquidation | Liquidation without legal successor |
|---|---|---|---|
| 1989 | 4,669 | 245 | 166 |
| 1990 | 14,867 | 632 | 202 |
| 1991 | 24,275 | 989 | 314 |
| 1992 | 18,052 | 1,422 | 419 |
| 1993 | 17,720 | 1,468 | 361 |
| 1994 | 17,089 | 1,480 | 634 |

Source: KSH 1994

During the period of the most rapid expansion of the small firm sector at the beginning of the 1990s, the failure rate of businesses was relatively low, considering their explosive growth on the one hand and the protracted economic recession on the other. Futo and Kállay (1994) explain this trend by pointing to the existence of so-called 'phantom organisations', that is businesses which although registered never actually engage in any kind of activity but are rather used as a vehicle for tax avoidance (Hoggett and Kállay 1993). This view is supported by Kállay et al. (1997) who estimate on the basis of Central Statistical Office data and tax returns that only about two thirds of registered enterprises in the Hungarian economy are actually operating. According to this data, highest amongst the non-operating companies are co-operatives and sole proprietors.

However, table 5.9. also indicates a slowdown in the number of new starts from 1992 onwards coupled with a continuing rise in the number of liquidations. Thus it would appear that as the early opportunities for profit taking diminish and demand constraints as well as legislative checks become more prevalent, the scope for continuation of either

unviable businesses or phantom companies narrows and we would expect to see a much greater turnover in the small business sector.

Thus far we have considered the size and characteristics of the Hungarian small firm sector based on official statistics only. Yet in the light of the barriers to both entry and operation we would expect to find small firms operating in the informal economy also. Research by the Foundation for Market Economy in Budapest on the informal economy in Hungary suggests that the income generated in this sector amounted to approximately 25 percent of GDP in 1994, or 18-20 percent when taking into account non-paid taxes and contributions not converted into income (Deszéri et al. 1994). Therefore, the official figures have to be interpreted with caution since a significant amount of small firm activity takes place outside the official economy, thus distorting the overall picture.

The evidence cited above on the size and characteristics of small firms leads us to number of conclusions. Firstly, the unprecedented growth of small firms, from the beginning of the 1990s, has resulted in significant changes in the size structure of the Hungarian economy. However, the growth has been particularly in the category of self-employed microenterprises, thus leading not to a full reversal in the inverted size pyramid typical of the socialist period but to a significant polarisation of economic activity. Employment in the small firm is not typically the main occupation but is often used to supplement incomes derived from main occupations or retirement payments. Microenterprises are most typically found in the services and trade sector. A slightly higher proportion of small and medium sized enterprises are found in manufacturing. Nevertheless, manufacturing is relatively underrepresented in small firm activities, indicating both the dynamics of structural change as well as pervasive internal and external constraints to long-term capital investment. As Gabor (1997) states

> ...the specific too-many, too-small syndrome experienced among small undertakings in Hungary today will not necessarily and automatically change

> when the original causes disappear. Unless effective remedy can be found, it may grow into a self-sustaining phenomenon, a kind of low equilibrium trap that would constrain economic transformation perhaps for a long time to come. (Gabor, 1997, p.167)

These policy implications will be returned to in chapters 6 and 8. Let us now consider the role that these small ventures play in the Hungarian economy.

### 5.3.3. The role of small businesses in the Hungarian economy

The preceding section sought to describe the size and characteristics of the Hungarian small firm sector. It was concluded that although small firms have experienced rapid growth, the small firm sector overall appears to be rather fragmented and shallow. This section will seek to analyse the relative role of small firms in the Hungarian economy, looking in particular at aspects such as employment, innovation, export potential and incomes.

One of the key problems of the Hungarian economy in transition, as outlined in paragraph 5.1., appears to be the rising unemployment levels, especially during the initial phases of transition, and the declining numbers of employed people. As the evidence from developed market economies suggest, small firms play an important role in job creation, especially during periods of economic recession (Storey 1994). In the case of the Hungarian economy, we would expect the significant expansion of the small firm sector to have an impact on overall job creation. This impact, however, is likely to be mitigated by the fact that many of the new ventures are very small and employment in the small firms is secondary. Nevertheless, the evidence presented in table 5.10. suggests that the share of micro and small firms in total employment in the economy is increasing, whilst the share of medium enterprises is stagnating and that of large firms declining. This increasing importance of small firms can be viewed, on the one hand, as evidence of the increasing strength of small firms and, on the other, as a weakness and

an effect of the relative decline in the large firm sector. Data on employment turnover (Kállay et al. 1997) appear to support the latter view and furthermore indicate that small firms are able to absorb only 80 percent of the labour shed by large firms. Thus, it would appear that the small firm sector cannot yet be unambiguously viewed as a viable employment alternative to the large firm sector.

Table 5.10: Total employment in enterprises by size class distribution in Hungary (in percent)

| | **1992** | **1994** | **1995** |
|---|---|---|---|
| Micro | 21.5 | 30.4 | 34.6 |
| Small | 9.9 | 12.4 | 13.1 |
| Medium | 20.5 | 19.4 | 19.0 |
| Large | 48.2 | 37.9 | 33.2 |

Source: Tax returns as quoted in Kállay et al. 1997

This finding, that the weight of small firms in the Hungarian economy is somewhat disproportionate to their numbers, is further supported by data on their contribution to GDP.

Table 5.11: Contribution to GDP by size in the business sector in Hungary (percent)[27]

| | **1992** | **1994** | **1995** |
|---|---|---|---|
| Small | 26.5 | 27.6 | 26.8 |
| Medium | 16.2 | 21.9 | 22.5 |
| Large | 57.3 | 50.5 | 50.7 |
| Total | 100.0 | 100.0 | 100.0 |

Source: Tax returns as quoted in Kállay et al. 1997

Even taking account of the existence of the informal economy, the contribution of small firms to GDP is not only relatively small, but has also not shown significant

[27] The Central Statistical Office does not provide a breakdown of GDP by size classes and the above data are arrived at by the authors through computations from tax returns.

improvements since 1992. The data suggest that the majority of national income in the Hungarian economy remains generated in the large firm sector.

Given the above findings and also taking into account the sectoral bias of small firms towards the service sector, we would expect small firms to play a relatively minor role in exporting activities, which have been one of the sources of economic growth in Hungary in recent years (NBH 1997). Indeed, in 1995, microenterprises and small firms combined accounted for only 26.6 percent of Hungarian exports, whereas large firms accounted for 51.9 percent (Kállay et al. 1997). However, small firms have been gaining ground, increasing their export turnover 2.6 times between 1992 and 1995, with medium-sized firms showing a 2.8 fold increase and large firms doubling their export turnover. However, research shows that only a small minority of small firms (about 10 percent) account for nearly three-quarters of export sales revenues (Bonifert et al. 1998) suggesting the existence of a small 'powerhouse' of small firms that disproportionately influence aggregate data.

A key role for small firms in the transition economies is their potential to influence market structures to dilute the dominance of large firms, thus contributing to efficiency gains. However, except for sectors where we have seen an explosive proliferation of small firms, such as commerce and real estate, large firms continue to dominate many branches of the economy.

Table 5.12: Distribution of branch turnover by enterprises in 1995 in Hungary (in percent)

| | Micro | Small | Medium | Large |
|---|---|---|---|---|
| Agriculture, game, forestry | 15.6 | 20.9 | 44.1 | 19.3 |
| Fishing | 32.1 | 29.8 | 10.9 | 27.1 |
| Mining | 4.1 | 7.7 | 26.2 | 61.9 |
| Manufacturing | 8.6 | 10.5 | 21.8 | 59.1 |
| Utilities | 0.7 | 0.7 | 4.4 | 94.3 |
| Construction | 25.0 | 25.4 | 27.4 | 22.2 |
| Commerce, vehicle service and maintenance | 36.1 | 26.2 | 21.1 | 16.5 |
| Catering, accommodation | 30.2 | 16.8 | 18.7 | 34.4 |
| Haulage, storage, PTT | 14.7 | 15.4 | 8.7 | 61.2 |
| Financial services | 10.6 | 14.3 | 33.9 | 41.2 |
| Real estate, leasing | 47.1 | 28.5 | 18.7 | 5.7 |
| Education, healthcare, social services | 55.0 | 32.1 | 8.5 | 3.6 |
| Other communal, social and personal services | 46.9 | 11.8 | 15.7 | 25.5 |
| National economy total | 22.3 | 18.1 | 20.8 | 38.8 |

Source: Tax returns as quoted in Kállay et al. 1997

Although the data in table 5.12. is not sufficiently disaggregated to allow for exact conclusions as regards market dominance in particular sectors and subsectors, it nevertheless highlights the continued market domination by large firms in a number of branches. Whilst effective competition policies and regulation of, for example, natural monopolies might mitigate some of the negative effects of distorted market structures, in the long run only vigorous new entry is likely to provide the kind of contest that is needed to spur enterprises into efficiency gains. Data on productivity gains compiled by Kállay et al. (1997) show that medium enterprises have exhibited the highest productivity gains since 1992 followed by large firms. The lack of capital investment and innovation[28] in small firms no doubt contribute to the relatively small gains amongst the small firms and microenterprises.

[28] Research in the UK has shown that innovative small firms exhibit higher-than-average growth of assets, earnings and exports (Wynarczyk et al. 1997). However, surveys conducted in Hungary suggest hardly any small firms have a R&D profile (Kállay et al. 1992) and the ones that can be identified are severely stymied by the lack of an appropriate support structure (Futo 1995). In particular, the dearth of venture capital financing (Karsai 1998) combined with restrictive monetary policies seriously impede technological developments.

The analysis of the role and relative weight of small businesses in the Hungarian economy supports the finding from section 5.3.2. Despite a measurable increase in the contribution of small firms to employment, GDP and export activity, large firms continue to enjoy a greater relative weight in the economy. However, in terms of incremental growth, it appears that on a number of indicators medium-sized enterprises show the most dynamic tendencies. However, there is little evidence to suggest that the current microenterprises are likely to swell in the near future the ranks of these growing and dynamic medium firms unless radical changes take place that incentivise entrepreneurs to forego their short-termist income and consumption maximisation in trade and other commercial undertakings and seek a longer term perspective in more productive economic spheres. There is evidence that small firms which are innovative and investment-oriented do exist (Webster 1992, Chikan 1997, Czako and Vajda 1993, Nagy and Soltesz 1996, Kirby et al. 1996, Futo 1995). However, Hungary as yet lacks a critical mass of such undertakings. Porter (1998) in his seminal work on the competitive advantage of nations forcefully demonstrates the need not only for healthy competition but also inter- and intra-firm linkages. However, in the light of the absence of a sufficient mass of small firms, examples of the emergence of constructive, productivity-enhancing linkages (Kuczi 1993) are likely to remain isolated.

Despite these shortcomings, there is evidence that Hungary has progressed towards European Union averages in size class distribution (MVA 1997). The following section seeks to analyse whether similar trends can be observed in the less-advanced transitional economy of Russia.

## 5.4. Small firm sector development in Russia

### 5.4.1. Historical roots

The Soviet Union was arguably the country of the Eastern bloc where central planning was most entrenched in economic structures and where private entrepreneurship was most absent. This relative deficit of private entrepreneurship was in the first instance a function of the lack of experience with private business prior to the Russian revolution in 1917[29], which contrasts with the Central European countries' experience with private entrepreneurship prior to World War II. Following the revolution, Patterson (1993) argues, ideological hostility towards private sector activities led not only to policies designated to eliminate them but also to minimisation of official reporting of this type of output. Thus, activities performed outside the state sector were not reported in official income statistics. Furthermore, centralisation and the elimination of small-scale activities were inevitable in order to mitigate the information problems associated with planning mechanisms.[30] Lastly, the planners' obsession with growth targets and in particular the emphasis on extensive growth entailing accumulation of labour and capital favoured the emergence of large-scale over smaller ventures (Gros and Steinherr 1995).

However, even the Soviet central planners were not entirely able to suppress private and semi-private activities. As Grossman and Treml (1987) reported:

> A very common practice, often on the scale of even a whole factory, is the use of a socialist facility by insiders as a facade for private business. This kind of crypto-private operation typically depends on resources stolen from the socialist sector, such as materials, equipment time, labor time and even customers. It is a major

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[29] Interviews with I.Kratko and V.Popov, Moscow Academy of Management, 8th April 1994, see also Ageev et al (1995).

[30] Nove (1983) reports the calculations of a Soviet economist estimating that there was a total of 2,700-3,600 million plan 'indicators' determined at all levels of Soviet bureaucracy.

source of private income, especially on a large scale. (Grossman and Treml, 1987, p.285)

This kind of behaviour is strongly reminiscent of Hungary's second economy although there are important differences in respect of the legality of the operations undertaken. Whilst in Hungary a variety of private and semi-private business forms were introduced in order to legalise the second economy, in the Soviet case the boundaries between the second economy and illegal activities remained largely blurred.

In addition to the inability of planners to entirely stamp out these parasitic private sector activities, there was also at times a recognition by the authorities of the beneficial aspects of small private sector activities. This can be traced back as far as the 1920s when Lenin under the New Economic Policy (NEP) reintroduced small-scale private retail and production units[31] in order to stem the rising tide of populist discontent and improve output and consumption levels (Patterson 1993). However, the failure and subsequent abandonment of the NEP under Stalin led to a resumption of nationalisation and heralded the return to forced industrialisation and monopolisation. It was only in the mid-1980s, with Gorbachev coming to power and the subsequent initiation of *perestroika* that the need for legalisation of small-scale activities once again appeared on the government's economic agenda. Thus, a variety of legal changes in 1986 and 1988 authorised individual and cooperative labour activities and brought about a rise in the numbers of small-scale establishments using these ownership forms. The choice of cooperative ownership forms as a vehicle for the promotion of small-scale activities was not accidental, given the continuing ideological hostility at the time towards private sector activities. These new ventures were essentially examples of private entrepreneurship, but the cooperative format provided a convenient ideological cloak, as

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[31] Some estimates put the output from *kustar* (rural based and complementary to farming) and *remeslo* (urban, non-factory industry) small-scale industry at a third of total industrial output at the peak of the NEP in 1926, in addition to which there was also a mushrooming merchant trading sector that was supplied both by the large state sector enterprises and small-scale industry (Banerji 1997).

well as enabling the influence of the party and trade unions to be maintained (Plokker 1990, Jones and Moskoff 1991, Nuti 1992, Gimpelson 1993).

The authorities were aiming to achieve three main goals through the promotion of small-scale activities. Firstly, on top of Gorbachev's agenda was the eradication of shortages in the economy and the existence of small-scale units was deemed to be essential as they could react more flexibly to consumer demands than their large-scale state-owned counterparts constricted by planning targets (Milner 1987, Plokker 1990). Secondly, co-operatives and individual labour activities were viewed as a means of mobilising additional labour, that of pensioners and housewives for example[32], in order to plug some of the shortages in the labour market (Plokker 1990, Malle 1991, Antosenkov 1991, Tschepurenko 1994). Lastly, the reforms were aiming to bring 'productive' parts of the shadow economy under government control, not least in order to mobilise the resources engaged within it and thus contribute to faster growth (Plokker 1990, Malle 1991, Nuti 1992).

Although cooperative and individual labour activities experienced rapid growth in the wake of these reforms (see Malle 1991 for estimates), their role in the national economy remained rather limited, with cooperatives accounting for example in 1988 for 0.3 percent of the total turnover in catering, 0.6 percent of all services (the two sectors in which cooperatives were most populous) and 0.03 percent of all consumer articles only (Plokker 1990). This is perhaps not surprising since their liberalisation was only partial and in reality cooperatives and individual labour activities were impeded in their development by legal constraints limiting their access to labour and material-technical resources (Nuti 1992) and granting local soviets powers over cooperative formation which were exploited through rent-seeking behaviour (Malle 1991, Antosenkov 1991). Despite the cooperatives being unable to fulfill the economic roles so ambitiously

[32] Indeed, the law on cooperative activities allowed participation of state enterprise employees in cooperative activities only in their leisure time (*v svobodnoe ot osnovnoi raboty vremya*) (Malle 1991).

assigned to them by the reformers under Gorbachev, they were nevertheless important in schooling a new class of entrepreneurs that had some rudimentary experience of operating in quasi-market conditions, and some of these enterprises later developed into medium-sized or even large firms (Tschepurenko 1994, Chepurenko and Vilensky 1996). However, the main thrust for the development of small firm sector activities came in the wake of post-Soviet systemic reforms and a host of legislative acts aimed at comprehensive liberalisation of private sector initiatives.

### 5.4.2. Small firm sector development in post-socialist Russia - an overview

Following the break-up of the Soviet Union, a series of legislative reforms[33] in the early 1990 paved the way for a comprehensive liberalisation of the small firm[34] sector in the Russian Federation resulting in accelerated growth in the numbers of small enterprises.

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[33] For a comprehensive summary of legal acts pertaining to the small enterprise sector see Ioffe et al. (1996).

[34] 'Small enterprises' were first defined in the 1991 Russian Federation Council of Ministers Decree 406 *O merakh po podderzhke i razvitiyu malykh predpriyatii v RSFSR* (On Measures for the Support and Development of Small Enterprises in the RSFSR) which set the maximum numbers of employees in small firms as follows:

| | |
|---|---|
| Industrial production and construction | 200 |
| Science and scientific services | 100 |
| Other production activities | 50 |
| Non-productive activities | 15 |

(Ekonomika i zhizn', July 1991)

However, later draft definitions used by the Anti-monopoly Commission and the Ministry of Economic Affairs of the Russian Federation modified this definition to include wholesale, retail and agricultural small firms (Tschepurenko 1993). A further modification was made in 1995 Law of the Russian Federation *O gosudarstvennoi podderzhke malovo predprinimatel'stva v Rossiiskoi Federatsii* (On State Support of Small Entrepreneurship in the Russian Federation) which set employment limits as follows:

| | |
|---|---|
| Industrial production and construction | from 100-200 |
| Science and scientific services | from 100-60 |
| Retailing and consumer services | from 15-30 |
| Catering and other non-productive activities | from 15-50 |

In addition, the law limited the share of equity capital in small firms to 25 percent and set criteria for the determination of the main activity of enterprises in an effort to classify more accurately sectoral activities given the often multi-profile nature of entrepreneurial activities (Ioffe et al. 1996). However, in addition, the draft tax code envisages an upper limit of 50 employees whilst some regions such as Moscow for example use their own definition. Thus there exists considerable confusion over definitional issues. Curiously, the definitions do not distinguish between small and medium enterprises, rather they are used in the sense of the German 'Mittelstand'. In the following analysis, we refer to small enterprises, small and medium enterprises and small enterpreneurship (*maloe predprinimatel'stvo*) synonymously using the 1995 definition, unless otherwise specified.

Table 5.13: Dynamics of small firm sector growth in the Russian Federation

| Year | No of small firms (1,000) | Rate of growth (previous 100, in percent) | Index of small firm sector growth (1991=100) |
|---|---|---|---|
| 1991 | 268 | 100 | 100 |
| 1992 | 560 | 209 | 209 |
| 1993 | 865 | 154 | 323 |
| 1994 | 896 | 104 | 334 |
| 1995 | 836 | 93 | 311 |
| 1996 | 645 | 77 | 240 |

Source: Goskomstat as quoted in Ioffe et al. 1996 and Gosudarstvennyi Komitet RF po podderzhke i razvitiyu malovo predprinimatel'stva (1997), own calculations

Table 5.13. highlights the initial explosive growth of small firms in Russia, with numbers more than doubling between 1991 and 1992. A number of explanations have been advanced to account for this rapid growth. Firstly, the high growth must be viewed in relation to the relative deficit of small enterprises prior to liberalisation (Kenter and Kroker 1995). Secondly, given the legacy of the shortage economy, buoyant demand for a variety of consumer products and services fuelled the entry of new businesses in a classical 'pull' scenario (Antosenkov 1991, de Melo and Ofer 1994, Belova et al. 1994). Lastly, economic policies in 1991 in respect of liberalisation, fiscal policies and privatisation favoured small enterprises over larger units, a distinction which became more blurred or even reversed in later policy measures under Gaidar and Chernomyrdin as Financial Industrial Groups moved to the forefront of economic policy-making influenced by political patronage (Tschepurenko 1994, OECD 1998).

However, the statistics[35] also indicate a slowdown in the births of new firms in 1994 and a subsequent contraction of the sector in 1996. This stagnation and contraction is more

[35] These data have to be interpreted cautiously since between 1994 and 1995 definitional criteria for small firms have changed. Official statistics are furthermore distorted by the non-reporting on the one hand and the existence of 'phantom' businesses, which are estimated to be around one third of registered businesses

difficult to explain. On the one hand, one could hypothesise a natural slowdown of small firm formation as sectors are reaching saturation point (Sutherland 1996). However, international comparisons regarding the density of small firms would appear to refute this argument.

Table 5.14: Numbers of SMEs in selected countries in 1995

| Country | Number of SMEs ('000) | Number of SMEs per 1,000 population |
|---|---|---|
| Great Britain | 2,630 | 46 |
| Germany | 2,290 | 37 |
| Italy | 3,920 | 68 |
| France | 1,980 | 35 |
| EU total | 15,770 | 45 |
| Russia | 836 | 5.65 |

Source: Ioffe et al., 1996, p.11

The figures suggest that far from reaching saturation point, Russia in 1995 arguably still experienced an *overall* deficit of small enterprises (some branches, in some regions, however, might well have reached saturation point). A nine-fold increase in the numbers of SMEs is required in order to reach European Union average SME densities.[36]

A common view regarding declining SME dynamics explains them in terms of the worsening business environment for small ventures (Gruhler et al. 1995, Vilenskii 1996, OECD 1998). On the one hand, small firms have been more adversely affected by transition-specific problems such as high taxation, legal uncertainty, fledgling capital markets and rampant inflation than large firms that were in a better position to lobby the

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(OECD 1998), on the other. However, survey evidence has shown that the general trends depicted can be viewed as accurate (Kroker and Kenter 1995).

[36] Estimates by the Ministry of Economy suggest a required fourfold increase in the numbers of SMEs in order to create an efficient competitive environment (OECD 1998).

government for favourable treatment. Furthermore, the initially favourable demand conditions that 'pulled' many small businesses into existence gave way to protracted recessionary tendencies[37], with demand in the domestic economy steadily declining, accompanied by a slowdown in demand in traditional export markets (UN/ECE 1997). On the other hand, the initially favourable treatment of small businesses by the government ceased during the shock therapy period with its emphasis on the creation of a level-playing field and even changed into a resurgence of discriminative measures (*Moscow News*, 19th March 1993). Goldman (1994), for example, cites policy changes at the local level where, in the case of Moscow, a crackdown on street traders took place in order to redress the image of Moscow's becoming a giant bazaar. Hanson (1994) points to evidence of so-called 'gate-keeping' activities by local authorities acting in conjunction with large businesses to ward off unwanted competition in return for a share in the monopoly profits. There is also a wealth of survey evidence pointing to increasingly hostile attitudes of the population towards '*spekulyanty*' - business people that exploit the economic turmoil to get rich quick (Tschepurenko 1993). In particular, such hostility is geared towards ethnic minorities[38] resulting frequently in restriction of business opportunities by local governments aimed at these groups of entrepreneurs (Radaev 1994). Thus small business is not only constrained by generally unfavourable macroeconomic conditions but also an at best ambivalent and at worst discriminatory attitude by various layers of government.

A further explanation for the slowdown in small firm births can be sought in the dynamics of small firm formation. This was initially strongly characterised by the syphoning of resources from large state-owned organisations (Bunin 1994, OECD

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[37] Retail trade, for example, one of the key sectors in respect of SME activity declined by 11.2 percent between 1994 and 1996 (UN/ECE 1997).

[38] The derogatory term '*chornye*' (blacks) is frequently used for people from the Transcaucasus states and almost universally synonymised with criminal activities in the small enterprise sector. Survey evidence suggests, however, that a vast majority of small business owners (84 percent according the Centre for Political Technology) are ethnic Russians.

1997).[39] The opportunities for such asset-stripping became increasingly limited in the wake of legal reforms (OECD 1997) and the realisation of the need for large size as a prerequisite for rent-seeking activities vis-à-vis the state (Alfandari et al. 1995). Lastly, given the increasingly hostile conditions under which small firms operate, declining numbers of registered small firms might be interpreted as evidence of the tendency to escape these pressures by operating in the black economy (Tsyganov 1992, *Moscow News* 18th February 1993, OECD 1997).

Although the rate of small firm sector growth in the Russian Federation lags behind the transitional forerunners in Central Europe, there are similarities in respect of sectoral distribution and size classes.

Table 5.15: Numbers of Russian small enterprises by sector (in percent)

| | 1991 | 1992 | 1993 | 1994 | 1995 |
|---|---|---|---|---|---|
| Industrial production | 14 | 11 | 11 | 14 | 15 |
| Agriculture | 1 | 1 | 1 | 1 | 1 |
| Transport and communication | 3 | 3 | 2 | 2 | 2 |
| Construction | 19 | 13 | 11 | 14 | 17 |
| Trade and catering | 46 | 49 | 46 | 47 | 43 |
| Supplies and sales | 2 | 3 | 2 | 2 | 2 |
| Information | 2 | 1 | 1 | 1 | 1 |
| Real estate | .2 | .2 | .3 | .2 | .3 |
| Market services | 3 | 4 | 7 | 6 | 5 |
| Other production | 2 | 3 | 3 | 2 | 2 |
| Communal services | 2 | 2 | 2 | 2 | 2 |
| Health and social maintenance | 1 | 2 | 2 | 2 | 2 |
| Education | 1 | 1 | 1 | 1 | 1 |
| Culture and art | 1 | 1 | 1 | 1 | 1 |
| Science | 4 | 6 | 8 | 6 | 6 |
| Financial services | 1 | 1 | 2 | 1 | 1 |
| **Total** | **100** | **100** | **100** | **100** | **100** |

Source: Goskomstat as quoted in OECD, 1998, p.32

As elsewhere in the region, trade and catering activities are most typical for small firms, accounting for almost half of all small enterprises in 1995. Given the adverse economic

[39] The State Committee for the Support and Development of Small Business estimates that about 35 percent of the Russian small businesses are spin-offs from large enterprises.

conditions outlined, this trend is not surprising since the level of investment required in these kinds of activities is lower than in other branches. As these types of small businesses are essentially cash-based, they have also been able to escape some of the worst excesses of the non-payment crisis plaguing the Russian economy. Furthermore, these businesses were addressing the obvious gap in the market left in the aftermath of a service-hostile command economy.

Industrial production is relatively underrepresented, accounting for only 129,000 enterprises or 15 percent of the total in 1995. About one third of those were active in engineering and metal working, followed by light industry (16.9 percent), wood manufacturing (12.1 percent) and food processing (9.9 percent) (OECD 1998). One positive trend here, however, is the steady annual growth in the numbers of manufacturing firms at a time when the sector as a whole and trade and catering in particular are experiencing contraction. Moreover, financial indicators suggest that industrial small firms accounted for 23 percent of profits of small firms, behind trade and catering and construction with 26 percent and 27 percent respectively (OECD 1998). Whilst this is partly a reflection of higher margins as a result of less intensive competition, it nevertheless signals an important economic weight for this sector. A relatively high percentage of small firms is also engaged in construction activities, accounting for 17 percent of small firms in 1995. These enterprises have also exhibited a high degree of adaptability, switching from declining markets of industrial and municipal housing construction to private housing, a development which has been accompanied by substantial investments (OECD 1998). There has also been an upward trend in the numbers of small firms in the science-related branches, a reflection of push factors at work generated by declining state funding for R&D (Batstone and Westhead 1996).

However, these figures have to be interpreted cautiously since, firstly, many of these registered enterprises are in fact non-operational. Attempts to construct surveys by the

European Bank for Reconstruction and Development (EBRD) based on current business directories reportedly ran into problems as many of these firms had either ceased trading or were non-traceable (interview with R.Müller-Hahnke, 20th November 1995). Secondly, one of the typical features of Russian small enterprises is their multi-sectoral profile, which was not captured in the official statistics up to 1995 due to definitional shortcomings (Goskomstat 1999). Given the greater degree of 'invisibility' of trading activities, it is likely that manufacturing is indeed overreported.[40] Thus, despite the trends towards growth in manufacturing, there appears still to be a substantial deficit of what one might term 'investment-profile' small firms.

The ownership distribution of small firms reflects progress in transition especially in the field of privatisation. The share of private small firms has continuously increased whilst the numbers of state-owned small firms is experiencing decline (Kenter and Kroker 1995, OECD 1998).

Table 5.16: Numbers of small enterprises, employment and financial indicators by ownership form in Russia in 1995 (in percent)

| | Federal | Municipal | Public | Private | Mixed | Total |
|---|---|---|---|---|---|---|
| **Numbers** | 2.3 | 1.8 | 1.0 | 84.3 | 10.6 | 100.0 |
| **Employment** | 7.8 | 3.3 | 0.9 | 67.9 | 20.1 | 100.0 |
| **Investment** | 5.4 | 1.6 | 0.4 | 56.8 | 35.8 | 100.0 |
| **Sales** | 7.3 | 2.2 | 1.4 | 67.6 | 21.5 | 100.0 |
| **Profits** | 5.8 | 1.3 | 0.8 | 69.2 | 22.9 | 100.0 |

Source: Goskomstat as quoted in OECD, 1998, p.35

Table 5.16. illustrates the predominance of private small firms in absolute terms in respect of numbers, employment and financial indicators. However, in relative terms,

[40] The director of the engineering firm 'Angmar' in Tyumen admitted during a visit in 1996 that the 'majority' of his turnover and profits now came from trading activities, primarily second-hand car sales.

those with mixed ownership forms appear to be the stronger performers. This trend can be explained by the relatively larger size of state-owned firms involved in mixed ownership businesses on the one hand and the lesser market pressures experienced by this type of business due to the sheltering role of the state-owned institution on the other (Kenter and Kroker 1995).

The Russian small business sector is mostly characterised by the presence of microenterprises, with an average number of employees of 7 in 1995 (OECD 1998). Time series furthermore highlight the trend towards smaller size classes. Science and industrial[41] small firms particularly strongly exhibit the trend towards microenterprises (table 5.17.). One explanation for this could be the increasing resort to part-time employment of particularly informal contacts, given the incentives of the fiscal regime to hide employment (OECD 1998).

Table 5.17: Average number of employees (full-time only) in Russian small firms

| | 1991 | 1992 | 1993 | 1994 |
|---|---|---|---|---|
| **Industry** | 48.5 | 34.8 | 24.6 | 23.0 |
| **Construction** | 34.9 | 30.0 | 25.8 | 23.8 |
| **Trade and catering** | 9.0 | 5.9 | 5.9 | 6.1 |
| **Other commercial activities** | 5.4 | 5.7 | 5.9 | 4.7 |
| **Science** | 11.0 | 7.9 | 4.8 | 3.8 |
| **Other** | 14.5 | 8.2 | 5.9 | 6.5 |
| **Average (unweighted)** | 20.5 | 15.4 | 12.1 | 11.3 |
| **Total (weighted)** | 20.3 | 12.6 | 10.0 | 9.2 |

Source: Goskomstat and Kenter and Kroker, 1995, p.31

[41] These figures have to be interpreted cautiously since sectoral employment limits in size class definitions affect the size of enterprises in the various branch categories.

The above statistical data on the Russian small firm sector raise a number of important points. Firstly, following an initial boom in small firm births, growth in the number of small firms has slowed considerably largely due to unfavourable external conditions for small entrepreneurship. Whilst at the end of 1995 small enterprises constituted 70 percent of all enterprises in the Russian Federation, they accounted for only 3.4 percent of all assets and 14 percent of employment (OECD 1998). Thus, there is as yet no evidence of significant alterations in the inverted pyramid structure typical of central planning. Indeed, in comparison to European Union countries and the transitional forerunners in Central Europe, the density of Russian SMEs is significantly lagging behind. In other respects, however, the Russian SME sector exhibits similarities to that of other transitional economies. Small entrepreneurship is largely characterised by the prevalence of microenterprises in what might be termed 'shallow' business activities such as trade and catering. However, even in these branches the deficit of SMEs is apparent.[42] Thus, whilst the Hungarian small business sector was characterised by the phenomenon of 'too many - too small', Russian small entrepreneurship is best described as 'too few - too small'. This phenomenon arises out of the dual pressures of barriers to entry and barriers to growth that militate against the emergence of all but the shallowest entrepreneurial activities on any significant scale. The nature and scale of these barriers will be examined in more detail in chapter 6.

### 5.4.3. The role of small enterprises in the Russian economy

Given the relative dearth of small firms in Russia, we would expect to find their role in the economy to be very limited. The lack of reliable and detailed statistics here prevents the painting of a fuller picture and therefore some crude general figures have to be relied on to assess the role of small firms in the Russian economy. At the end of 1996, the economic weight and importance of small firms in Russia can be summarised in terms of the following parameters:

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[42] Account has to be taken here of regional differences, too, which will be taken up in chapter 7.

- 70 percent of all registered enterprises
- 3.4 percent of main assets
- 14 percent of employment
- 12 percent of GDP
- 34 percent of all contracting work in construction
- 30-35 percent of all profits
- 20 percent of Russian exports

Thus, as was indicated above, small firms have not yet displaced large enterprises as the backbone of the Russian economy. Indeed, despite the emergence of small firms and decentralisation of large firms, the Russian economy remains heavily concentrated, which in itself constitutes a barrier to the development of small firms (Tschepurenko 1993, Goskomstat 1999). The very small percentage of assets employed in the small firm sector highlights the limited extent of the sector's productive potential so far.

As far as employment is concerned, small firms have not shown sufficient employment creation potential to counteract the rising unemployment emerging as a result of the contraction of the large firm sector (Ioffe et al. 1996). The evidence as regards job creation of the small firm sector, albeit ambiguous, points to a disappointing performance. Whilst Vilenskii (1996) reports a rise in average employment in small firms of 0.8 percent, employment in the small firm sector overall decreased by 2 percent between 1994 and 1996 (Rutland 1996) or 14 percent according to OECD estimates (OECD 1997). Of course, this development might be accounted for by the exit of small businesses from the official economy into the black economy on the one hand and by the propensity to underreport employment in response to punitive wage taxes on the other. However, research by Richter and Schaffer (1996) indicates that job creation is lowest in the smaller size classes of Russian firms (although this finding might be a reflection of defensive actions by the large firms in the sample that continue to create

jobs in an adverse economic environment in order to secure government assistance[43] rather than an indication of sustainable job creation). Interestingly, it is brand-new (or *de novo*) firms which according to Richter and Schaffer show the greatest net job creation. Thus, demands for the a greenfield approach to small firm development as voiced by Goldman (1994) find support in empirical data and should be taken account of by policy-makers. Despite the ambiguities surrounding data on employment, however, it must be concluded that the full employment potential of small firms in Russia has not yet been realised and that an expansion of the stock of new SMEs is likely to impact on employment by the small firm sector.

There are, however, a number of areas where small firms have made or are starting to make a positive impact. Firstly, given the low supply elasticity of the large firm sector, the elimination of shortages has been achieved through the expanded role of small firms. Goldman (1994) describes the situation following the liberalisation of small businesse activity in the early 1990s as follows:

> Almost overnight, all over the country, the streets were packed with individuals seeking to sell anything that was portable - handicraft products, resold state store goods, imported goods. Some, out of desperation, sold their most valuable household possessions. Given that the country's shelves had been virtually empty a few weeks earlier, this was a remarkable turnaround. (Goldman, 1994, p.129)

However, over the following years, as the Russian economy sank further and further into crisis, Western products replaced Russian ones on the shelves of the Russian traders.[44] Much of this achievement was based on shuttle-trade operations of entrepreneurs buying goods cheap in the west (and east) and selling them dear in Russia.

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[43] Alfandari et al. (1995) report that large size and the maintenance of employment in large firms is a factor significantly influencing government financial transfers.

[44] For example, the newspaper *New Europe* reported on the plight of Russian dairy producers that are unable to compete with Western imports due to poor organisation, lack of reliable supplies, outdated equipment and lack of working capital. Cheese production in Russia is reported to have fallen from 440,000 tonnes in 1990 to 172,000 tonnes in 1997 with imports of 125,000 tonnes in 1997. (*New Europe*, April 26 - May 2, 1999)

Given the trade surplus that Russia had achieved through raw material exports, these increases in imports did not cause concern. However, both from the point of view of external economic policy and sustainable small firm sector development, a greater trend towards domestic production with a degree of import substitution would be desirable, as the Chinese reform effort demonstrates (Oi 1992, Goldman 1994). However, given the radically different economic environment in Russia with its hostility towards any kind of long-term productive activity, this is unlikely to occur without a concerted government effort.

Secondly, small firms have played an important role in fiscal stabilisation, one of the weak areas of stabilisation policies. Increasingly, small firms have plugged the fiscal revenue gap as left by the ailing large firm sector. In Moscow for example, SMEs' contributions amounted to 50 percent of regional revenues.[45] Yet, the increasing fiscal pressures on small firms are also one of the most significant obstacles hindering their development (Avilova et al. 1996) and effective fiscal policies need to address the non-payment problem of large enterprises in order to prevent a further slide of small firms into the shadow economy.

Thirdly, a proliferation of science-based small firms has occurred in the wake of the Academy of Science restructuring and defence conversion. Given the crisis that is plaguing traditional research and development structures in Russia (Kuznetsov 1995), David Dyker argued that "...in the Russian case the technologically dynamic small or medium sized firm ...whether a start-up company as such or a downstream company, must willy-nilly move to the centre of the stage" (Dyker, 1993, p.4). SMEs, emerging largely from traditional R&D structures, have increasingly become a vehicle for innovations and technology-transfer in high-tech industries, accounting for example for 50 percent of all laser enterprises (Bzhilianskaya 1997). However, it would be

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[45] Interview with M.Milova, Moscow City government, Department for the Development and Support of Small Business, December 1995.

premature to emphasise the role of the technological spin-offs in innovation and technology transfer since much of the unbundling is part of a perverse restructuring by the large organisation involving asset stripping. Afanassieva and Couderc (1998) demonstrate instances of this in the case of defence restructuring:

> As a rule, the small firms were created anew with the enterprises' own assets and with private person's resources, or using the enterprises' divisions as a base. The problem here is that most of the profitable activities of the enterprise can be spun-off, but the costs and overheads which arise from maintaining the unprofitable parts of the enterprise and the social amenities remain with the enterprise as a whole. (Afanassieva and Couderc, 1998, p.45)

Thus, the emergent small firms are strongly parasitic on the large organisations to which they are tied. Aside from these technological spin-offs, moreover, Russian small firms in general are characterised by a low level of technology which, according to the government, is one of the key weaknesses of the Russian small firm sector (Ioffe et al. 1996).

It can be concluded from the above observations that, as was the case with co-operatives in the Gorbachev era, the expectations associated with the development of small firms in post-socialist Russia were high. However, despite an initial explosion in the numbers of small firms, growth rates were soon stagnating and even declining. Moreover, the sector exhibits serious structural weaknesses in terms of sectoral, size and employment composition. The Russian small firm sector therefore appears to be suffering from a 'too few, too small' syndrome. There is thus far no evidence to suggest that small firms are providing the catalyst that can pull Russia from its deep and prolonged recession. The role of small firms in the Russian economy remains subordinated to the activities of the corrupt-bankrupt industrial-financial oligarchy that has largely determined the dynamics of the Russian economy. However, the *potential* for a more constructive role of small

firms in the Russian transition remains, providing the sector can escape the low disequilibrium trap.

## 5.5. Conclusion

This chapter has investigated the development, structure and role of small firms from a macro-perspective in two transitional economies that exhibit wide divergences in their experience with economic transition. Hungary, with its emphasis on gradual microeconomic reforms is considered to be a transitional forerunner, well placed to meet the challenges of European Union accession. Russia, on the other hand, with its long legacy of central planning and its ill-advised attempt at shock therapy, remains deeply mired in economic recession. Given the differences in initial conditions and subsequent transitional performance, it was to be expected that small firm sector development exhibits differing dynamics in the two countries. Indeed, the analysis of aggregate data has shown that Hungary is starting to approximate size distributions observed in the market-type economies of Western Europe, whereas the Russian economy continues to exhibit high concentration levels despite intitial high growth rates of small firms. The relative weight of small firms in the respective economies also varies with Hungarian small firms accounting for a higher share in GDP and employment than their Russian counterparts.

Nevertheless, a number of common trends have been observed. In structural terms, the small firm sector in both economies is characterised by fragmentation and overtertialisation. The greatest growth dynamics have been observed with respect to very small firms engaged in trade and services - the type of *petit bourgeois* enterprise so derided by Marxist economists (Hardy and Rainnie 1996). It therefore appears that the economic potential, or positive externalities, of small firm development in respect of innovation and job creation is not yet maximised. A second common trend relates to factors accounting for the births of new small firms, which appear to be influenced not

only by 'push' and 'pull' factors but also by a deeper underlying process of embourgeoisement or 'emancipation' (Futo and Kállay 1994, Bartlett and Hogett 1994). Lastly, both countries experienced distinctive phases of SME development; first, entrepreneurship in some form of second economy under central planning followed by explosive growth during initial liberalisation and a subsequent slowdown or stagnation in the rates of new firm establishments in response to external constraints.

These common trends do not appear to be unique to the two countries that have been considered here (see for example Bartlett and Hoggett 1994, Smallbone and Piasecki 1995, Isakova 1997, Smith 1998). This seems to lend weight to the hypothesis that there are transition-specific factors influencing the dynamics of SME development in the region which need to be considered in policy-making. In the following chapter, the nature and context of small-firm policies at the national level in Russia and Hungary will be assessed.

# Chapter 6: National-level small firm policies in Hungary and the Russian Federation

The preceding chapter sought to analyse the evolution as well as the size and structure of the small firm sectors in Hungary and the Russian Federation. An analysis of statistical data has highlighted the different dynamics in SME development in the two countries, with Hungary attaining size class distributions similar to those observed in developed market economies of Western Europe, and Hungarian SMEs accounting for a significant and increasing share of, for example, output and employment. In Russia, on the other hand, size structures skew towards large enterprises (consequent on central planning and remaining largely unchanged) and the contribution of SMEs to output and employment, whilst showing a positive trend, remains suboptimal. Despite these differences, however, a number of commonalities in the development of small firms in the two countries can be observed.

Whilst liberalisation measures in the early 1990s, as a component of systemic reforms, promoted the rapid numerical growth of Hungarian and Russian small businesses, the SME sector in both countries is dominated by very small enterprises often run on a part-time basis and sectorally biased towards trade and services. The sector's relative weight in the respective economies is much less than policy-makers initially hoped for. This chapter seeks to analyse barriers to the entry and growth of small firms in the two countries and argues that, in the light of pervasive market imperfections and market failures, government intervention is of pivotal importance in order to avoid the emergence of a self-sustaining low equilibrium trap (Gabor 1997). The second part will consider, in retrospect, government policies in the two countries, firstly in terms of aims

and objectives and, secondly, in terms of the instruments employed. This is followed by an assessment of how relevant these policies actually are in relation to the environment within which they are operationalised. The main focus here will be on explicit small firm policies, that is, on direct support measures (see 2.2.), although attention will also be given to the broader framework within which these policies emerged. Lastly, in addition to government policies, a plethora of private and semi-private support institutions has mushroomed with the aim of supporting small business in the two countries; their role and impact will also be given consideration.

## 6.1. Barriers to entry and growth of Hungarian small businesses

Prior to 1989, the entry and growth of Hungarian small business was constrained by a variety of systemic barriers largely of a legislative character (see 5.3.1.). Following systemic reforms, these barriers have been largely eliminated through a variety of legislative acts[1] that formed part of the initial transitional package of liberalisation, stabilisation and privatisation. Key acts between 1987 and 1992 included legislation on the transformation of business organisations and business associations, laws on income tax, corporate tax, value-added tax and social security contributions, court registration and legal supervision of companies and decrees on the transformation of state-owned enterprises and privatisation of state-owned property, to name but a few. Yet a number of characteristics of the Hungarian small business sector point to the persistence of entry and growth barriers:

[1] For a detailed summary of relevant legislation see Kállay et al. 1992, 1996 and 1997.

- The informal economy in Hungary remains large generating an estimated 18-20 percent of GDP.

- The vast majority of Hungarian small businesses operate in sectors that require minimum amounts of capital to start up and are characterised by low rates of investment.

- Self-employment remains the most typical form of Hungarian small business and the job creation capacity is limited by the part-time nature of employment which SMEs generate.

- Even in sectors where small businesses are very numerous, and one would expect to see competitive market structures, monopolisation of market segments and the operation of price cartels[2] occur. Consequently, competition remains restricted.

The evidence therefore suggests that, despite the progress in transitional reforms, there remain instances of market imperfections, market failures and regulatory barriers that stymie the growth of new and existing small firms and hence provide a rationale for government intervention. The following sections analyse in greater detail the nature and scope of these barriers.

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[2] Sik (1994) describes the Hungarian taxi industry, which in Budapest outnumbers New York taxis by four times, as a 'barter-corruption-cartel-ridden organisation' that will be 'lastingly distorted by the

### 6.1.1. Compliance costs

Bannock and Peacock (1989), using the example of VAT, have demonstrated the relatively higher compliance costs of small firms with government regulation compared to larger firms. This places small firms at a relative cost disadvantage. Governments should therefore seek, they wrote, to eliminate such 'artificial' costs in order to aid the creation of a level-playing field. The incidence of high compliance costs for small firms is typical for transitional economies where legislative frameworks continue to undergo fundamental changes and where compliance costs are exacerbated by a premium imposed through the fast-changing and fluid nature of legislative developments.

In Hungary, surveys have shown that administrative encumbrances are considered a serious problem for nascent and existing entrepreneurs (Csako and Vajda 1993, Deszeri et al. 1994, OECD 1996). Entrepreneurs face a number of hurdles when seeking to start up in business. Compulsory start-up requirements include an entrepreneur's certificate from the local municipality, a certificate documenting the absence of a criminal record from the Ministry of Interior, cash and invoice books from a stationary office which have to be certified by the Tax Office from which a tax ID and VAT registration (if required) has also to be obtained, registration with the Social Insurance Directorate and the Chamber of Commerce. Additionally, the entrepreneur might be required to register the firm at the Court of Registration (excepting sole traders) and open a bank account. Dezseri et al. (1994) estimate the start-up costs pertaining to legislative compliance in 1993 at HUF 3,000-10,000 for sole traders, HUF 40,000-60,000 for partnerships and HUF 40,000-80,000 for Limited Liability Companies. However, these figures paint only

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behavioural features of the vulture and the great inertia of their networks and organisations'. (Sik, 1994,

an inadequate picture since they capture neither the time nor the effort of the entrepreneurs engaged in obtaining the relevant permits. As Dezseri et al. (1994) note

> Thus it is not uncommon that entrepreneurs running around to establish their limited liability companies are being sent around between the Statistical Office, the Headquarters of the Tax and Financial Control Office and its district branches in idle running. Relatively new organisations like registration courts work rather slowly and the consequences of this are born by the entrepreneurs. For instance during the months until the order of registration, the liability of limited liability companies is only nominally limited. (Dezseri et al., 1994, p.23)

Thus, compliance costs are problematic, not through the existence of government regulation *per se*, but because of the institutional hiatus caused by systemic reforms. Laszlo Kállay, formerly of the Foundation for Market Economy and later Director of the Institute for Small Business Development at the Hungarian Ministry of Trade and Industry, argued that "Large phases of the transition were spontaneous with laws following events...." which led to "...phases of wild capitalism with widespread tax evasion, unfair competition and a huge hidden economy."[3] These concerns are also echoed by entrepreneurs who have said that "The tax system has been a chronic problem for years. The tax rates and taxes to be paid are considerable. What is more, regulations change every year and the uncertainty also causes much discomfort." (I. Böröczffy as quoted in *The Hungarian Economy*, Feb.1999, p.2). Surveys of entrepreneurs also highlight compliance costs associated with the fiscal regime as a key problem for the development of entrepreneurship in Hungary. They have argued that while the overall level of taxation remains high, in line with tight budgetary policies pursued by the central government, fiscal regulations including the level of taxation,

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p.288).

income brackets, depreciation allowances, cost deductions and the forms and varieties of taxes have changed on an irregular and frequent basis (see Deszeri et al 1994, Kállay et al 1996 and 1997). Again, it is not so much the level of taxation *per se* that causes problems for entrepreneurs but the costs associated with keeping up-to-date with the relevant changes.

Given that it is the quality of legislative changes and, in particular, the complexity and frequency of change rather than the high fiscal costs *per se*, further deregulation is likely to have a minimal impact on the competitiveness of small firms. Above all, a stable legislative environment coupled with ease of access is pivotal in order to ease the artificially high compliance costs that the small firm sector faces (interviews with L.Kállay, 16th September 1993, M.Jászai 21st September 1993, B.Ignacz, 25th September 1993, P.Szirmai, 28th July 1997, see also OECD 1996).

Aside from compliance costs, financial barriers have been highlighted, both in the secondary literature and during the interviews with entrepreneurs, policy-makers and objective outsiders, as a significant factor distorting small firm development in Hungary. The following section looks in closer detail at the issue both from a macro- and microeconomic perspective.

### 6.1.2. Financial barriers

One of the most pervasive problems associated with small firm development is the inability to access finance at competitive prices. In the light of asymmetric information, principal-agent problems and high objective risk and transaction costs, market

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[3] Interview with L.Kállay, 16th September 1993.

imperfections or gaps occur where banks limit the amount of loan finance available to small firms (Storey 1994). Equally, the problems associated with the ability of small firms to access small amounts of equity finance are well-documented (Storey 1994, Stanworth and Gray 1991, Commission of the European Communities 1996). These problems are exacerbated in the Hungarian case through a number of factors. Firstly, reflecting the increased commitment to the attainment of macroeconomic stability, interest rates, initially at negative real levels, have increased substantially (interview with P.Szirmai, 28th July 1997, NBH 1997, see also Lavigne 1995). Moreover, the spread between deposit and lending rates, albeit decreasing, remains not insignificant (NBH 1997). Furthermore, given the precariousness of the budgetary situation, the continued pressure to service the external debt and the subsequent susceptibility to external shocks like the Russian financial crisis of 1998, macroeconomic policies are likely to remain volatile, at least in the short term. Therefore, the majority of credits granted are likely to be short term in nature (NBH 1997).

In addition to these macroeconomic problems, there are specific microeconomic issues that affect lending to SMEs. The initial phases of transition were characterised by close links between the banks and the large enterprise sector. To some extent these links were the result of cross-ownership structures between banks and industrial enterprises and continued state-ownership in the banking sector, with the added conflicting interests resulting from it (Várhegy 1993). More pervasively, however, links resulted from the legacy of non-performing loans inherited by the newly-emerging banks which inexorably tied the fate of the banks to the performance of the inefficient enterprise sector. Subsequent debt write-offs and shares-for-loans deals have cleaned the portfolios of commercial banks to some extent but often not destroyed the links between banks

and large firms. A Nyiregyhaza owner of a small private bakery said in 1993 that the local state-owned bakery finds it much easier than the small private bakeries to access loans from the banks because of long-established lending relations between itself and the former state bank.[4] A further issue to consider in this context is information asymmetries which are likely to be greatly reduced in the case of large firm - bank relations due to the nature of linkages described above and exacerbated for small firms due to their relative and absolute *de novo* character. These heightened information asymmetries are likely to impact on the loan portfolio of banks vis-à-vis small enterprises. A factor related to the newness not only of small enterprises but also of financial institutions, are transaction costs such as evaluation and monitoring costs accruing to the banks. The financial institutions are likely to have no track record in dealing with small firms and thus systems for lending to small firms are likely to be in their infancy and transaction costs high (OECD 1996, Pawlowska and Mullineux 1999). Aniko Soltész of the Hungarian SEED Foundation argued that the combination of high interest rates coupled with high transaction costs in lending make investment in bonds a much more attractive proposition for banks compared to lending.[5] Lastly, the banking sector, despite institutional reforms, remains strongly concentrated, with large banks accounting for 57 percent of credit stock in 1996 and 51 percent of all deposits (NBH 1997).[6] The structure-conduct-performance paradigm informs us of the negative effects of such highly concentrated structures on behaviour and consequent poor economic performance of institutions.

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[4] Interview with A.Kovacs, 24th September 1993.
[5] Interview with A.Soltész, 27th September 1993.
[6] In respect of size distribution, the banking sector is not dissimilar to the rest of the economy, with a growing number of small banks, unable to significantly challenge the supremacy, albeit declining, of the large banks, and a relative absence of medium-sized banks.

There are also a number of specificities pertaining to small firms in respect of financial dealings with the banking sector. Small firms typically lack relevant information on bank loans and relevant expertise on presenting proposals to banks (interviews with I.Kovacs 28th September 1993, T.Hagymási, 22nd September 1993, P.Süle 27th September 1993, G.Borbély 25th July 1997). These problems are likely to be heightened by the speed and fluidity of reforms on the one hand and the particular features of the small enterprises on the other, including their relative newness and lack of relevant expertise of the founder.[7]

A related problem is the ability of SMEs to provide collateral for loans, a potential which is likely to be reduced in the case of new entrepreneurs due to the legacy of the socialist system that limited the accumulation of wealth and the possibilities for accruing inflation-proof assets. In Nyíregyháza the director of the Local Enterprise Agency told in an interview of nascent entrepreneurs coming to the agency and seeking advice as to whether livestock was eligible as collateral, since that was all that they owned.[8] As banks usually look for collateral in the region of 150-200 percent of the credit sum in order to insure against the perceived lending risk, 'small credits' are the predominant result (Futo 1997, OECD 1996).

The above transition-specific issues, both at the macro- and micro-levels, have significantly influenced the scale and scope of loan finance available to small enterprises. The following table gives an overview of the aggregate assets and liabilities

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[7] The managing director of a Budapest-based computer company said in an interview that his predominantly technical background and expertise had hampered first attempts to secure loan finance from commercial banks in Budapest. At the time of the interview, he was considering approaching the Local Enterprise Agency for help with preparing the relevant financial documentation (interview G.Bényei, 30th July 1997).

[8] Interview with I.Kovacs, 21st September 1993.

of Hungarian commercial banks and highlights the relative role and importance of lending to small enterprises.

Table 6.1: Assets and liabilities of Hungarian banks according to enterprise size (HUF billion)

| | Assets | | | Liabilities | | |
|---|---|---|---|---|---|---|
| End of Year | Credits to Enterprises | Credits to small Enterprises | Net Domestic Assets | Enterprise Deposits | Small Enterprise Deposits | Net Domestic Liabilities |
| 1989 | 473.9 | 18.7 | 1,794.6 | 179.9 | 23.9 | 1,794.6 |
| 1990 | 592.1 | 44.0 | 2,032.5 | 277.7 | 36.6 | 2,032.5 |
| 1991 | 703.9 | 61.4 | 2,504.3 | 324.5 | 57.5 | 2,504.3 |
| 1992 | 691.8 | 76.2 | 2,858.7 | 395.5 | 61.8 | 2,858.7 |
| 1993 | 676.2 | 85.7 | 3,361.9 | 499.7 | 33.2 | 3,361.9 |
| 1994 | 780.5 | 89.2 | 4,048.1 | 518.3 | 32.0 | 4,048.1 |
| 1995 | 911.5 | 71.1 | 4,440.4 | 616.8 | 33.9 | 4,440.4 |
| 1996 | 1,202.8 | 62.4 | 4,776.1 | 759.0 | 47.3 | 4,776.1 |

Source: National Bank of Hungary 1997

The volume of credits as a percentage of GDP is 18 percent in Hungary, below the average of the other Central European countries (35 percent) and significantly below that of the European Union average of 60-80 percent (Futo 1997). The figures show that small firms accounted for a very small proportion of these already small credits with 1.2 percent of domestic credit stock and 1.3 percent of net domestic assets of the banking sector. Thus, it is safe to assume that lending to small firms from the banking sector is almost negligible, a reflection of the features discussed above. Furthermore, the table highlights the expansion of credits to small firms in the period 1991-1994 and a

subsequent tailing off accompanied by a rapid growth in credits to large firms. Futo (1997) argues that banks are reluctant to withdraw completely from the small enterprise segment of the market due to the deposit function of small firms, yet, as the table highlights, deposits from small firms account only for a minute proportion of overall deposits. The Hungarian journal *The Hungarian Economy* supports this view and writes "Financial institutions expect primarily commission-revenues from small- and medium-sized enterprises. They still very thoroughly think over the granting of loans to this circle." (*The Hungarian Economy*, February 1999).

Another noteworthy feature of bank lending to small firms in Hungary is that, whilst credits in the economy are overwhelmingly short-term, 63 percent of small business loans are investment loans and long-term business credits, with small businesses accounting for 12 percent all long-term loans (NBH 1997). This predominance of longer-term loans in small business lending is likely to be a reflection of the plethora of preferential loan schemes available to small firms (accounting for about half of small firm loans), which are largely foreign-financed and often take an explicitly long-term view in recognition of transition-specific domestic short-termism (interview with G.Borbély 25th July 1997). Moreover, small firms are likely to resort to other financing means such as leasing to satisfy their demand for short-term working capital in the light of the funding gaps in the loan markets (interview with G.Borbély, 25th July 1997, see also Webster 1992).

The high real interest rates referred to above are compounded by the size premium charged to small firms which, at approximately 7 percent higher market rates than for large firms (Futo 1997), lies substantially above the European Union average of 2-3

percent (Storey 1994). Whilst in market-type economies this premium is a reflection of the relatively greater risk of lending to SMEs, a similar argument does not easily hold water in the Hungarian case since. As was illustrated in chapter 5, failure rates, at least officially recorded ones, of small firms were not yet especially high in the mid-1990s. A more relevant explanation can be seen in the fact that despite institutional reforms and modernisation in the banking sector, competition remains limited in the banking sector due to segmentation and specialisation of banks (Várhegy 1993, Borish et al. 1997).

Thus, bank financing for small firms remains woefully inadequate and frequently ranks highest amongst the difficulties experienced by small firms (Webster 1992, Czako and Vajda 1993, OECD 1996). István Kiliti, a small business owner, said that "It is a serious problem that small- and medium-scale entrepreneurs can take out loans with difficulty, banks are cautious, they request triple cover as security, which most of the entrepreneurs are unable to meet." Another Hungarian businessman, István Böröczffy, argued that "The majority of entrepreneurs cannot take out loans...because of the 27% interest rate." (quoted in *The Hungarian Economy*, February 1999).

Moreover, this problem is not mitigated by the emergence of alternative capital markets. The Budapest stock exchange, despite showing the highest growth in dollar terms of the emerging capital markets in 1996, remains (even in comparison to modestly developed stock markets in market-type economies) undercapitalised (World Bank 1996) and suffered from the emerging market crisis in 1998. Furthermore, private debt and equity are increasingly crowded out of the market as the government seeks to finance the deficit through non-inflationary means (interview P.Szirmai, 28th July 1997, see also Lavigne 1999, Schuler 1998). Thus, in addition to the prohibitively high transaction costs associated with the raising of equity finance, the infant nature of the capital

markets makes the possibility of this type of finance less likely. The development of venture capital, albeit on estimates more advanced than in the other transitional forerunners, is hindered by the lack of a legal framework for the development of venture capital institutions and by the contradictory taxation as a result of the undefined legal status (Karsai 1998). It is therefore not considered to have a great impact on the provision of finance to SMEs in the short to medium-run.

To conclude, the theoretical problems raised in relation to financing of SMEs are borne out by the empirical evidence which suggests that, after some initial enthusiasm by financial institutions, there appears to be a significant and widening gap in the market for small firm loan finance. Moreover, where loan finance is made available, it is typically in the form of 'small and expensive' loans (OECD 1996). At least in the short term it is also highly unlikely that stock markets or venture capital are going to significantly impact on small firms' financing needs although particularly venture capital warrants further attention by policy-makers especially since its development is impeded by the lack of an appropriate legal framework.

### 6.1.3. Information barriers

Whilst the lack of relevant information available typically ranks quite low in surveys of the difficulties experienced by entrepreneurs (Czako and Vajda 1993, OECD 1996), it nevertheless warrants a closer look for a number of reasons. Firstly, entrepreneurs when questioned on the difficulties that they are experiencing are often unaware that problems such as the ability to raise finance at reasonable costs or indeed the sale of their products

in national or international markets[9] are linked to information problems. Secondly, despite the fact that the lack of information is not considered to be a serious problem, surveys have highlighted increased demand for consultancy services (OECD 1996) and indeed the market for technical consultancies in Hungary is expanding (Futo 1995, Kirby et al. 1996). Thirdly, one of the most comprehensive surveys of Hungarian small businesses suggests that the pace of innovation in Hungarian small business is deplorably slow and that the businesses are ill-prepared to face global competition (Chikan 1997). The lack of strategic business planning and information management highlighted in the survey has to be viewed as one of the key determinants for poor performance. If small businesses want to survive the growing competition (in itself already ranked as one of the biggest difficulties facing small firms), then the availability of up-to-date and relevant information is crucial. In other words, "...the need for information is there but *awareness* of this need is not." (Brusco, 1992, p.189).

However, even given the recognition of the need for information in order to sustain competitiveness, markets for information are notorious for failure since information carries features of a public good and, for many small firms, markets for information do not exist even in developed market economies (Brusco 1992). These problems are compounded in the case of transition economies and Hungary for a number of reasons. Hungary under central planning, like other economies in the region, was (due largely to the degree of centralisation) notoriously inefficient at the collection and dissemination of information. Yet the disintegration of the system has presented significant problems

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[9] For example, a small textile company in Nyíregyháza was producing coverings for car seats. Demand was initially buoyant as people tended to keep cars over long periods of time and the poor quality of Eastern European manufacture meant that the original coverings wore out quite quickly. However, as more and more people started buying Western models of cars, the firm found it increasingly difficult to sell its products and the lack of relevant marketing know-how was a serious barrier to development (interview B.Ignacs, 25th September 1993).

in the initial phases of transition, as the institutional hiatus blocked even existing information flows and caused generally chaotic conditions (Goldman 1994). Another legacy of the socialist period was the almost complete absence of the most basic information markets, with even business directories being a rarity.[10] Lastly, the pace of technological innovation, which intensified over the last decades, left Hungary relatively untouched and the rapid and ongoing integration of Hungary into the world economy is likely to present an additional shock to an already volatile economy. Thus, new mechanisms for the dissemination of information need to be developed rapidly which require, due to the nature of the problem, constructive government intervention.

In chapters 4 and 5 the actual and potential role of Hungarian small businesses has been demonstrated. As the preceding analysis, based on secondary literature and interviews with key stakeholders, revealed, this potential remains stymied by a variety of obstacles arising from government intervention and associated transaction costs as well as from general and transition-specific market imperfections and failures in the provision of especially finance and real services. Following Storey (1994), given both the economic potential of small firms and demonstrated market failures, the Hungarian government has a decisive role to play in stimulating the development of small firms. The following section seeks to demonstrate that in the Russian Federation similar forces impeding the development of small firms are at work, albeit in greater magnitude.

[10] In the more peripheral regions of Hungary such as SSB, this problem was still manifest in the early to

## 6.2. Barriers to entry and growth of Russian small businesses

The removal of systemic barriers to small firm development in the Russian Federation, and in particular legislative changes[11] that liberalised entrepreneurial activities, sparked a wave of new firm births at the beginning of the 1990s. Yet, as was shown in chapter 5, the Russian small firm sector exhibits a number of weaknesses that point to barriers to development and growth:

- Initial high growth rates in the numbers of small firms were followed by a trend of stagnation and decline which cannot be adequately explained in terms of market saturation arguments.

- Comparisons with developed market economies and other transitional economies in the region reveal that Russia has not yet broken the size structure imbalances inherited from central planning and that the small firm sector as a whole is best characterised in terms of 'unsaturated' market structures.

- Russian small businesses are characterised by their low capital and technology-intensity and operate mainly in sectors such as trade, distribution and petty services that require minimum amounts of capital.

- The economic potential of small firms has not yet been realised and their economic role remains subordinated to the bankrupt and corrupt large firm sector.

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mid-1990s (interview L.Roka, 21st September 1993).

Thus there appear to be strong external pressures that stymie the development of small firms. The following section seeks to analyse instances of market failures and imperfections as well as factors in the business environment that are distorting small firm growth.

### 6.2.1. Compliance costs and the fiscal burden

In previous chapters, the relative cost disadvantage that small firms are facing in relation to compliance costs with government legislation have been outlined. Given the precariousness of the Russian legal framework, with changes occurring at times on a daily basis, compliance costs can be expected to constitute a serious impediment to small firm development. Indeed, surveys have repeatedly ranked legal instability as the main problem for small firm activity (Avilova et al. 1996, Chepurenko et al. 1995).

The uncertain legal environment affects both the start-up and the expansion phases of small firm development. For start-ups, the bureaucratic hoops that small firms have to jump through mean an inordinately lengthy registration process of between 2 and 3 months, of which one month is usually spent on the collection and preparation of various documentation required by the banks, tax authorities, the municipality and other public bodies, and the remaining 2 months are taken up by the various layers of bureaucracy processing the claim. The fees associated with registration are not insignificant and varied, depending on the region, between US$ 750 and 2,500 in 1994

[11] For a summary of legislation pertaining especially to the development and support of small businesses in the Russian Federation from 1991 see Ioffe et al. 1996.

(OECD 1998). The process is, even for the best-informed, an inordinately lengthy one and shortcuts via the engagement of law firms are expensive.[12]

Furthermore, a number of entrepreneurs reported the need to 'oil the wheels' of official bureaucracy to speed up the processing of the claims.[13] There is a persistence of rent-seeking activities by local officials which in cases is also exploited by the large firm sector as it seeks to maintain monopolistic market structures. These local 'gate-keepers' thus act so as to "...strengthen local monopoly and ...are motivated to do so if they can extract a share of monopoly profit as condition of registration or of favourable local tax treatment and the like...." (Hanson, 1993, p.48).

In addition to costs related to start-up, there are also a significant compliance costs in the development phase of small businesses. The most notable ones are in respect of compliance with tax laws, which are notorious in the Russian case for their complexity and the frequency with which they change. In June of 1995, an average small incorporated business in the capital Moscow needed to pay the following direct taxes:[14]

- profit tax at 38 percent (excepted are activities such as banking, insurance, profits from gambling and video hire businesses where the tax can be up to 90 percent)

- transport tax at 0.4 percent of sales or in the case of trading enterprises 0.03 percent of annual turnover

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[12] A private law firm interviewed in St.Petersburg reported margins of 200 percent on processing of registrations for small businesses. In the view of the owner of the law firm, very few small businesses are therefore able to take advantage of legal representation (interview B.Nikolaev, 15th April 1994).

[13] Based on interviews with small business owners in St. Petersburg, Moscow and Tyumen in 1994, 1995 and 1996.

[14] Since that date, a number of changes have been made in order to simplify and ease the burden of tax collection. The 1995 Law on the Abridged System of Small Enterprise Taxation, Recording and Reporting has for example sought to introduce tax licences to limit the administrative burden of

- capital gains tax at 2 percent of gross capital gains

- tax on high wages, wages that exceed six times the minimum wage of 20,500 roubles taxed at 35 percent

- tax for the support of housing and socio-cultural institutions at 1.5 percent of sales

- tax for the support of educational establishments

- advertising tax at 5 percent of expenditure on advertising

Additionally, small firms are also subject to a host of indirect taxes imposed at both federal and regional levels such as duties, excise taxes and VAT.

As these taxes, and the way in which they are calculated, are subject to frequent changes, small entrepreneurs face high compliance costs. Mistakes are costly because they can result in accrual of tax liabilities which can lead to serious liquidity problems or even bankruptcy. Furthermore, the average level of taxation was, at around 51 percent of profits in 1995, high by international comparisons and constitutes a further hindrance to small firm development. Given that large numbers of Russian small businesses also pay criminal groups protection monies to varying extents[15], it is not

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complying with multiple taxes. Some regions have also used their discretionary fiscal powers to ease the burden of taxation. However, the reality remains a very fluid, complex and punitive tax system for SMEs.

[15] Russians refer to these protection rackets as *krysha*, meaning literally roof over ones head. *The Economist* recently reported that the cost of such protection typically runs in the region of 10-20 percent of profits (*The Economist*, August 28th 1999). Of the 6 entrepreneurs interviewed in Russia, 3 admitted to

surprising that businesses are blocked in their development and/or are forced to exit the official economy. Thus, there was broad agreement among the key informants interviewed in Russia, that the legislative environment creates a significant burden for SMEs and places them at a relative disadvantage vis-à-vis larger counterparts that are more easily able to avoid punitive taxation and can employ their own security. Although there remains a paucity of data, especially on the costs associated with racketeering, compliance costs for Russian small businesses are clearly an area that requires closer government attention. A second rationale highlighted during the field research and from secondary sources relates to financial barriers.

### 6.2.2. Financial barriers

As has been highlighted in previous sections, the issue of market failure in respect of small firm financing has been well documented (Storey 1994). In the Russian case, the situation is further complicated by the existence of transition-specific problems in the evolution of capital markets and financial institutions. Table 6.2. highlights some of the key parameters in the evolution of Russian banking between 1992 and 1996.

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having paid some form of protection money but would not disclose any information about it as they

Table 6.2: The evolution of Russian banking (end-year, unless otherwise stated)

| | 1992 | 1993 | 1994 | 1995 | 1996 |
|---|---|---|---|---|---|
| Number of operating credit organisations* | 1713 | 2019 | 2517 | 2295 | 2030 |
| Licences withdrawn (number, cumulative) | | 13 | 78 | 303 | 592 |
| Charter capital requirement for new banks (thousand US$) | 214.4 | 70.6 | 1244.7 | 1291.5 | 3648.9 |
| Real monthly refinance rate of CBR** | -12.2 | -6.9 | 4.4 | 7.6 | 6.5 |
| | percentage share of GDP | | | | |
| Credit from monetary authorities to commercial banks | 15 | 5.1 | 2.4 | 1.1 | 0.6 |
| Bank credit to non-financial sector | 33.6 | 20.4 | 19.6 | 12 | 10 |
| Interbank credit received | | 3.2 | 4.9 | 3.9 | 3.1 |
| Gross assets of the banking sector | 88 | 54 | 56 | 36 | 36 |
| Household deposits | 1.9 | 2.4 | 4.2 | 4.3 | 5.3 |
| Houesehold deposits outside Sberbank | 0.3 | 0.9 | 1.7 | 1.5 | 1.4 |

* 1360 at end-1991
** yearly average of real monthly rates; for 1992: February-December
Source: West Merchant Bank 1997

The initial phase of financial sector development was characterised by an explosion in the number of new banking institutions, facilitated by weak regulations governing the entry of new banks. Enterprises exploited the situation by setting up their own banks in order to secure access to cheap credits.[16] Lax monetary control during that period resulted in negative real interest rates (Lavigne 1995, Granville 1995). Banks were thriving as they profited from hard currency dealings or from acting as conduits to

considered this information as sensitive not only to their business but also their personal livelyhood.

channel state subsidies and soft loans to the enterprise sector (Tompson 1997). A tightening of macroeconomic policies and more prudent bank regulation and supervision resulted in a reduction of liquidity and entailed some bank closures. However, the emergence of bond markets, in particular in GKOs (*gosudarstvennye kratkosrochnye obligatsii*), offered banks new liquid, high-yield assets by means of which many managed to stay afloat. Credits to the non-financial sector, already low in comparison to other transition economies, continued to fall as banks switched to the more lucrative business of dealing in government securities.

Table 6.3: Assets of the Russian banking sector (trillion roubles at 1st January)

| | **1996** | **1997** | **July 1997** |
|---|---|---|---|
| Total assets *of which* | 490.1 | 643.1 | 686.7 |
| Credit to non-financial sector | 33.5 | 29.4 | 31.0 |
| Credit to banks | 10.2 | 8.9 | 7.6 |
| State securities | 11.4 | 19.9 | 23.2 |
| Other securities | 4.7 | 8.7 | 10.2 |
| Share of long-term credit in all credit to non-financial sector | 4.5 | 4.4 | N/A |

Source: WestMerchant Bank 1997

The increasing exposure of banks to government securities for principal assets finally unravelled in the summer of 1998 as Russia *de facto* defaulted on its rouble denominated debt and the large parts of the Russian banking sector either collapsed or relied on government bail-outs for survival. In addition to these structural weaknesses of the Russian banking sector, there are two further points worth mentioning. Firstly, despite attempts to promote bottom-up development of new banks through low entry

[16] Interview with Prof. B.Yeremin, 15th April 1994.

requirements, the old state banks (*spetsbanki*) continue to dominate segments of Russian banking, not through having undergone any significant restructuring but by virtue of a continued segmentation of the market and implicit government guarantees through ownership links. Thus Sberbank, the former state savings bank, for example, accounted for 76.2 percent of all household deposits in 1997 (*Izvestiya*, 3rd June 1997). Secondly, banking is spatially concentrated around the commercial hubs of Moscow and St.Petersburg. The 22 largest Russian banks (excepting Sberbank) are all situated in Moscow and together accounted for over 70 percent of all banking assets in 1997 (WestMerchant Bank 1997). These banks are also politically very powerful as they helped to bankroll Yeltsin's re-election. In return for this they were favoured in shares-for-loans deals that enabled them to build up vast empires in the form of financial-industrial groups (*The Economist*, 28th August 1999).

How do these developments in the Russian banking sector affect the small firm sector? Firstly, banks have been very reluctant to lend to the private sector, especially on a long-term basis, due to macroeconomic instability, tighter government monetary policies restricting credit supply and the possibility of making high profits in government securities. This reluctance to lend has been exacerbated by microeconomic factors, especially the lack of standardised accounting procedures and the non-payment crisis in the enterprise sector which arose in response to the exogenous tightening of monetary conditions (Alfandari and Schaffer 1995). Thus credit as a percentage of GDP was at 10 percent in 1997 well below that of other transition economies, and has shown a tendency to decline (WestMerchant Bank 1997). Secondly, given the absence of experience in private sector lending, especially to the small firm sector, there are high

monitoring and evaluation costs to banks.[17] Thirdly, as banks are increasingly tied to the large firm sector through the formation of financial-industrial groups, most of the loan portfolio is tied to the industrial enterprises in the group (Freinkman 1995). This constitutes a continuation of the 'soft money' circuit that existed under central planning.

The importance of financial barriers to the development of small business has been recognised by policy-makers (Ioffe et al., 1996, Vorokhalina 1996, Ermakov 1995). This was echoed during the field work by policy-makers who unanimously agreed that access to finance at competitive rates constituted a severe problem for Russian small firms, although opinions were divided as to the degree of severity.[18] However, as survey evidence shows, there are different kinds of financial constraints and the effects of it are not evenly distributed among Russian small firms.[19] Firstly, investment finance has suffered mostly from the inertia of the banking sector, with a notable worsening of investment conditions in small firms between 1994 and 1996. This development does not come as a surprise given the relatively low share of long-term loans in banks' lending portfolio combined with the uncertain macroeconomic situation that was outlined in chapter 5. The firms worst affected by the lack of investment finance are firms in engineering and innovative activity and in manufacturing and construction. In other words, firms with a typically investment-intensive profile suffer most from the

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[17] The international donor community showed awareness of this problem and a number of programmes financed by the World Bank and the International Monetary Fund have been seeking to introduce international banking standards to Russia. The EBRD, in preparation for the launch of its microcredit programme in Russia, was running a series of training courses for bank managers in risk assessment and monitoring techniques and also customer relations. Rainer Müller-Hahnke, a senior consultant with the EBRD, said in an interview that they had to start working with the Russian managers from scratch as even basic commercial skills were absent (interview R.Müller-Hahnke, 20th November 1995).

[18] The policy-makers in Moscow tended to consider tax-related problems as the most important obstacle for small firm development, whereas in Tyumen opinions were more divided. I will return in chapter 7 to these regional differences.

[19] The following analysis is based on surveys carried out by the Russian Independent Institute for Social and Nationality Problems, Moscow with the Institute for German Economy, Cologne and the University

lack of competitive finance. However, the survey also shows a progressive worsening of investment capital availability in trading firms from 1994 to 1996, which seems to be indicative of the precariousness of the small firm sector as a whole in the light of the banking crisis. Secondly, growth firms are much more sceptical about future investment compared to 'stable' firms, i.e. those that have not shown increases in turnover during the survey period. Thus, markets particularly fail to address the financing gap associated with the growth of small firms. Thirdly, there are distinct regional variations in the availability of finance for small firms, with enterprises in Moscow being traditionally in a more advantageous position compared to regional enterprises. However, the last of the surveys conducted in 1996 shows a much-increased pessimism about future financing possibilities, especially investment finance, among Moscow entrepreneurs.

A number of factors appear to influence this trend, including the banking crisis in 1995 (which affected especially the Moscow banks), the development of a banking infrastructure in the regions and, lastly, the increased competitive pressures in the capital, where some branches of small firm sector activity are reaching saturation levels (see chapter 7 here for regional variations). Furthermore, recent research has shown that the share of long-term credits in the balance sheets of Moscow banks is below that of the banking sector average, indicating a more robust development of 'investment banks', often successors of *spetsbanki*, in the regions (Efremov 1997 as quoted in OECD 1997). Fourthly, small enterprises that have built steady supply links find access to financial resources relatively easier, since suppliers often extend credits or act as guarantors. Particularly advantaged are firms that have built up supply links with foreign companies although, given the low level of foreign investment in the Russian Federation, these

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of Wolverhampton's Russian and East European Research Centre for the TACIS-ACE programmeT94-

appear to be the exceptions rather than the rule. Lastly, the survey revealed that very few firms seek financing from the banking sector - only approximately 20 percent of those surveyed - received loans from either the spetsbanki or private commercial banks. Around half of the entrepreneurs in the survey manage without loan finance whereas about a third satisfy their financial requirements from loans obtained from business partners or private persons.[20] It appears that small firms are able to survive the hostile conditions through the resurrection of formal and informal networks that continue to replace market relations. There is also a wealth of anecdotal evidence to suggest that many of the informal networks are also used as conduits for laundering illegal monies.

There is no doubt that financial barriers constitute an important impediment to the development of Russian small firms, albeit to varying degrees. Those firms that are surviving are relying increasingly on non-market mechanisms for securing financial resources and on self-financing (Ioffe et al. 1996). Perversely, attempts by the government to monetise the economy through prudent fiscal and monetary policies have led to a situation that Gaddy and Ickes (1998) describe as a 'virtual' economy, in which barter trade[21] and informal and formal networks regulate much of the economic activity. The small firm sector is increasingly sucked into this economy, which enables the survival of some but stunts the growth of the sector overall. In order to address the problem effectively, account needs to be taken of the particular features of the Russian case, especially the continuing volatility of the commercial banking sector and the

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[20] This was echoed during a number of interviews with the Russian entrepreneurs. The capital for the setting up of sawmill in Tyumen, for example, came from a number of partners that had originally set up a cooperative in 1988 which was later converted into a limited liability company (interview P.Krasnov, 7th February 1996). The founding capital for the Moscow food-processing company 'Agrobolt' which made Russian salads and snacks, was raised by the family of the owner Leonid Gofman (interview with L.Gofman, 20th April 1994).

[21] According to surveys by the Russian Economic Barometer, barter trade was estimated to account for 45 percent of industrial sales in April 1997 with further rises expected (OECD 1997).

tendency to replace market relations with formal and informal forms of networks which are gaining increasing prevalence as reform progress is stalled.

In addition to financial barriers, a further market failure highlighted in the secondary literature and in interviews with the stakeholders pertains to information problems.

### 6.2.3. Information problems

One of the striking features of surveys seeking to identify problems of the Russian small firm sector is that access to relevant information is not perceived as an important obstacle (Avilova et al. 1996). This was further highlighted during the interviews with the Russian small business-owners, where there appeared to be a general consensus that they 'do know their business' but are unable to develop due to the lack of finance and the punitive tax burden. However, the interviews also revealed that small firms are indeed in need of so-called real services, although that need is often not being recognised. The survey by the Russian Institute for Social and Nationality Problems, for example, revealed that, in 56 percent of the enterprises surveyed, own costs were the key determinant in price formation and that the influence of demand and competitors was of only marginal importance in strategic planning. These examples highlight the fact that far from being perfect, markets for information are very underdeveloped and high quality information, for example, on market trends and volumes, is rare and expensive. Although a number of governmental and non-governmental organisations specialising in the provision of real services have emerged, their coverage is patchy and the services provided tend to be low-cost and low quality (this issue will be returned to later in the chapter). As was the case with financial services, Russian small firms are typically trying to compensate for the lack of formal sources of information through informal

business networks. However, those are not a perfect substitute for well-functioning markets or formal network structures of information. As the Russian small firm sector grows and market structures become more mature, the availability of information and particularly of good quality information is an important factor that is likely to influence competitiveness.

In addition to the above, small businesses in Russia are hindered in their development by the generally unfavourable macroeconomic environment. Over the last decade, Russia has experienced a recession that has dwarfed that of the 1930s Great Depression. As real incomes have declined, output has collapsed and investment come to a standstill, the level of real demand in the economy is very low. In the summer of 1998, Moscow - the only 'bubble' of normality in Russia, all but collapsed as the financial system folded. Whilst in the early 1990s small firm development was riding the wave of recession, even acting to some extent as a buffer, the continuous worsening of external conditions has taken its toll. Furthermore, the entrenchment of criminal groups and corrupt officials is adding to the already high costs of conducting business in Russia. In social terms, entrepreneurship, if not stigmatised, continues to be regarded somewhat ambivalently and a culture of peer support has not emerged.[22] If the small firm sector is to break out from the trap of low incomes, low investment and low growth, government needs to take a more active role. On the one hand, government needs to ease the regulatory burden that it imposes on the small firm sector, and on the other, should intervene where markets are functioning imperfectly or where markets do not exist. However, whilst these 'arguments from principle' for policy-intervention are recognised, policy-makers see 'arguments from practice' as a key rationale for

[22] Interview with V.Radayev, 21st November 1995.

developing policy. Thus, the importance of small businesses in job creation, supply of consumer goods, innovation and in competition was continuously highlighted by the policy-makers that were interviewed. There appeared to be a clear political reasoning in their support for small firm policies. This was perhaps most forcefully expressed by the head of the Moscow City Government's Department for SME Support who answered to the question as to why he considers support for SMEs necessary that "When a man has his own business, he has no time to waste on demonstrations and politics." (Y.Yegorov, 13th April 1994). Whilst this could be viewed as an aim, it also served as a raison d'etre for the development of small firm policies.

The preceding sections have shown that there are broad similarities in the barriers to the development of both Russian and Hungarian small firms that can be classed as 'system-specific' barriers, i.e. those associated with the processes of marketisation and institution-building that Eastern Europe is undergoing. Furthermore, many of these disadvantages of small firms that have been highlighted here have also been observed in the countries of the European Union and the rest of the world (Commission of the European Communities 1996). The differences between the two countries in barriers to SME development lie therefore not so much in the nature of the barriers but more in their scale, scope and persistence. The extent to which demonstrated market failures or compliance costs are taken account of in the formulation and implementation of small firm policies will be explored in the next sections.

## 6.3. Hungarian government policies towards SMEs

Whilst macroeconomic policies in the monetary and fiscal areas clearly have an important impact on the development of small firms in Hungary, the following section will primarily focus on meso-level policies, that is policies designed specifically for small firms. However, as the two are in many instances connected, reference will also be made to macroeconomic policies as and when relevant.

A number of governmental institutions with relevant tasks have emerged at the national level.

The Hungarian Foundation for Enterprise Promotion (*Magyar Vallalkozasfejlesztesi Alapitvany*, MVA henceforth)

The Foundation was set up in 1990 following an initiative by the Hungarian government to strengthen and expand Hungary's small firm sector. According to its founding charter, the Foundation is declared to be autonomous and non-profit making. Thus, although the government owns a stake in the foundation, it is essentially divorced from governmental bodies.[23] Alongside the Hungarian government, which was with 3 billion HUF the largest founding contributor, a number of banks and business organisations made up the original founding capital of 4,236,800,000 HUF (MVA 1993). In 1990, the Foundation was selected by the EC to receive finance in the context of the PHARE small firm development initiative and was thus responsible for the distribution of ECU 59 million, the same amount being co-financed from domestic

sources, both governmental and private, including financial institutions (MVA 1996). Increasingly other funds have also been channelled through MVA such as money from the British Know-How fund and the German START programme as part of the donor's effort to coordinate technical assistance programmes in the region (interview with J.Burns, 16th September 1993). Thus, although the Hungarian government is a founding member of the organisation, MVA stands alongside other governmental institutions with a relative degree of autonomy from direct governmental influence.

The aim of MVA is to promote the development and growth of a private small firm sector in Hungary. Its objective as stated in the founding document, is the promotion of professional, entrepreneurial and market development and the strengthening of the capital assets of small and medium-size private enterprises, to develop the culture of enterprising and to establish new enterprises (MVA 1993 and 1996). This in fact constitutes a number of different, albeit compatible, objectives which are defined with varying degrees of concreteness. The vagueness of some of the objectives, such as the promotion of professional, entrepreneurial and market development, has a popular appeal; however, it is scarcely suitable to the measurement of the relative effectiveness of policies. It also disguises the trend towards shifts in emphasis of objectives over time and the interpretation and operationalisation of these objectives by MVA personnel. During the early fieldwork in 1993, senior MVA managers stressed the importance of infrastructure creation as a key objective of the organisation. J.Burns, a Coopers & Lybrand consultant and programme director of the CEC-PHARE SME programme, said that the establishment of a business infrastructure for SME support, including the setting up of high-quality counselling and training systems for SMEs, was the key priority for

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[23] Interviews with I.Maróczi, 17th September 1993, J.Burns, 16th September 1993 and G.Borbély, 25th July

MVA.[24] In the same vein, I.Maróczi argued that the key objective of small firm policies, as carried out by the foundation, was the development of an entrepreneurial culture and an infrastructure for entrepreneurship. In order to attain especially the former objective, I.Maróczi argued for the necessity of increasing the numbers of small firms in the Hungarian economy so as to create a widespread and more deeply embedded culture of entrepreneurship among the Hungarian population (interview I.Maróczi, 23rd November 1993). By 1997, there was a noticeable shift in the emphasis of the objectives of the foundation. In a speech to the Hungarian parliament on 9th May 1997, the Hungarian Finance Minister Dr. Peter Medgyessy argued that:

> The government considers that at the moment not the number of enterprises must be increased but quality improvement is necessary. Larger performance, a larger role in employment must be assisted and the chances of existing enterprises for development need to be improved. (translation of text provided by Centre for International Private Enterprise, Budapest).

This change in strategic focus was confirmed in interviews with MVA officials with, for example, the acting Phare programme director Z.Kondor arguing that, in order to address the changing needs of the Hungarian SME sector, classical start-up support was no longer a key priority. What was needed was " quality rather than quantity" (interview with Z.Kondor, 25th July 1997). Thus, whilst the overall objectives of MVA remained in place, a shift in the overall approach to SME support can be discerned. On the one hand, this change has its origins in the recognition of the changing needs of the Hungarian SME sector (MVA 1997). On the other hand, these developments are driven by the need of MVA to adjust to the phasing out of EU Phare support and the preparation, both of

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1997.
[24] Interview with J.Burns, 16th September 1993.

the enterprise sector and governmental institutions, for integration into the EU (interviews with Z.Kondor, 25th July 1997, G.Borbély, 25th July 1997). An additional factor, however, needs to be taken into account in order to fully understand the shift in priorities. The setting up and the evolution of MVA have been strongly influenced by outside models for SME promotion. In 1993, J.Burns argued that "We (*the consultants advising MVA*) were familiar with the British systems and that is what we implemented... As yet we don't know whether it will work in Hungary." (interview with J.Burns, 16th September 1993, italics added). G.Borbély said in 1997 again "What we have is the English and the Irish system...." (interview with G.Borbély, 25th July 1997). In Britain during that period, there was a noticeable change in the discourse on approaches to SME support with the emphasis being shifted away from the traditional unselective approach promoting start-ups towards a more selective approach favouring particular types of small firms (Storey 1994, Bridge et al. 1998). This experience has informed strategic thinking in Hungary also, as the British model has been adopted and emulated.[25] This adoption is not only visible in the overall approach and objectives, but also in areas of operationalisation including the idea of one-stop-shops for SMEs.

In order to facilitate the attainment of the objectives that were outlined above, a network of Local Enterprise Agencies (LEAs) was established which in turn oversaw the development of a network of local sub-offices. The LEAs, if they already existed in some form, had to raise HUF 100,000 before being eligible for another HUF 600,000 (100,000 from "original" MVA capital and 500,000 from the EU). Considering the relatively high contribution from EU funds it is hardly surprising that the LEAs have to fulfil another condition in order to receive the MVA funds. All LEAs

[25] Interviews with Z.Kondor, 25th July 1997 and C.Ivanyi, 23rd July 1997.

had to employ foreign consultants for the development of a business plan for their respective regions that identified opportunities for potential growth of small firms. In 1991, LEAs were established in six counties - Szabolcs-Szatmár-Bereg, Szolnok, Borsod-Abaúj-Zemplen, Fejér, Somogy and Tolna - the selection being based on the prior existence of local foundations rather than as part of a regional development strategy (interview with J.Burns, 16th September 1993). The formation of the first-tier network of LEAs was completed in 1994; however, the number of sub-offices continues to grow.

In order to achieve its objectives, MVA, with the aid of technical assistance from European Union experts, has developed a number of instruments. Table 6.4. highlights the concentration of MVA resources on financial programmes, which accounted for 73 percent of resources. It is interesting to note, however, that the resources committed to financial services have declined since 1990 with a slight increase in 1995 only. The development of the LEA network ranked second in terms of resource commitments with 21 percent, followed by services with 6 percent of total resources committed.

Table 6.4: MVA Programmes 1990-1996 (HUF million)

| Programmes | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | Total |
|---|---|---|---|---|---|---|---|---|
| Assistance to SME programmes through LEA network | 0 | 178 | 469 | 558 | 1,118 | 1,398 | 1,486 | 5,207 |
| - LEAs | 0 | 178 | 469 | 512 | 1,112 | 1,394 | 1,474 | 5,139 |
| - bank network | 0 | 0 | 0 | 46 | 6 | 4 | 12 | 68 |
| Financial programmes | 4,369 | 1,638 | 1,649 | 1,157 | 1,525 | 2,337 | 1,501 | 14,176 |
| - PHARE credit* | 0 | 0 | 820 | 640 | 130 | 545 | 596 | 2,731 |
| - Micro-credit | 0 | 0 | 160 | 320 | 740 | 795 | 846 | 2,861 |
| - Capital credit** | 0 | 0 | 0 | 0 | 0 | 400 | 0 | 400 |
| - MVA credit* | 4,369 | 1,411 | 247 | 0 | 0 | 0 | 0 | 6,027 |
| - Reorg Start credit* | 0 | 0 | 0 | 0 | 500 | 500 | 0 | 1,000 |
| - Start Guarantee*** | 0 | 227 | 422 | 197 | 155 | 97 | 59 | 1,157 |
| Services | 15 | 47 | 14 | 214 | 230 | 310 | 309 | 1,139 |
| - Training | 0 | 11 | 6 | 63 | 43 | 78 | 65 | 266 |
| - Publications | 0 | 0 | 0 | 143 | 138 | 173 | 50 | 504 |
| - Research | 15 | 33 | 1 | 1 | 4 | 30 | 6 | 90 |
| - Information systems | 0 | 0 | 1 | 1 | 40 | 15 | 35 | 92 |
| - Assistance to interest representations | 0 | 3 | 6 | 6 | 5 | 14 | 44 | 78 |
| Conferences | 0 | 0 | 0 | 0 | 0 | 0 | 6 | 6 |
| Euro-Info Centre | 0 | 0 | 0 | 0 | 0 | 0 | 10 | 10 |
| - Tender assistance to SME interest representations and non-profit enterprise promotion institutions | 0 | 0 | 0 | 94 | 56 | 69 | 93 | 312 |
| Total | 4,384 | 1,863 | 2,132 | 2,023 | 2,929 | 4,114 | 3,296 | 20,741 |

*Total credit line available to SMEs with the contribution of the NBH and the trade banks

**not yet been launched

*** Credit amount made available to entrepreneurs through credit guarantee schemes

Source: MVA as quoted in Kállay et al. 1996 and 1997

Given the predominance of financial instruments, a closer look at those is necessary. The first observation relates to the demand for preferential loans. All of the schemes were heavily oversubscribed, the Phare loan and microcredit scheme by 54 and 53 percent respectively until 1996 (MVA 1997). There are also significant regional variations in the demand for preferential loans (see chapter 7). Secondly, even credit schemes like START or the microcredit scheme have tended towards the upper limit of the permissible loan scale. For example, 35 percent of the total START loans was over HUF 5 million and 55 percent of successful microcredit applications were for credits exceeding HUF 5 million (Laky 1994 and Vajda 1996). Thus the fact that only a small number of entrepreneurs have been reached through the schemes is not solely a function of the limited amount of total credit available but also of the disbursement of it. Another interesting feature is the sectoral distribution of preferential loans. Whilst manufacturing tends to feature prominently among the successful applications (22.7 percent for START for example), the vast majority of credits go to enterprises in the trade and services sector (Laky 1994 and Vajda 1996), a sector that is booming in any case. It also fails to coincide with the policy priorities of the government that argued "...primarily manufacturing enterprises, enterprises creating jobs and performing residential services, need to be supported." (Dr.Peter Megdyessy, Finance Minister of Hungary, in speech to parliament on 9th May 1997). Neither did preferential loans succeed in promoting mass entry as "The supply of the preferential loans...was not really abundant. The banks had to refuse a part of the applicants due to the tightness of the credit limits." (Laky, 1994, p.28). Another noteworthy feature is that, despite many of the supported enterprises being established enterprises, albeit very small, the subsequent job creation through expansion was relatively low (Laky 1994). A more successful feature of the preferential credit schemes, is the low rate of failure observed thus far (Vajda 1996, MVA 1997).

A number of conclusions can be drawn from the above findings. Firstly, the enterprises receiving preferential credits broadly follow the pattern of the typical Hungarian small firm - sole traders, very small and primarily engaged in trade and service activities. There appears to have been no coherent attempts to address enterprises that are particularly stymied by the imperfections in capital markets - i.e. manufacturing enterprises or technology-based firms that need to make long-term investment decisions. The preferential loans are filling only a small gap in the market, without fundamentally addressing the pervasive market failures that have prevented the emergence of a competitive small firm sector.[26] Thus, financial services largely served a demonstration purpose rather than addressing market failures (RIPA and MACON 1997).

As regards the other activities of MVA, namely the LEA network and service provision, a number of weaknesses can be discerned. Firstly, the LEA network is based on a regional/administrative division rather than a functional or sectoral one. Thus, the development of network brokerage services as witnessed for example in the Third Italy is unlikely to emerge as there is little scope for cross-fertilisation outside the administrative boundaries.[27] Moreover, MVA itself and the LEAs that are modelled on it are highly hierarchical in structure thus limiting the scope for effective promotion of clustering. Lastly, the services provided through MVA, apart from being relatively poorly resourced, tend to crowd towards the large-volume, low-cost end of the market[28],

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[26] A research report sponsored by MVA concluded that "The fact that the supply and demand of credit could not meet each other and the use of loans could not become the assistance of development of those businesses that wanted to develop slowly and to undertake only small burdens is a serious failure of the economic policy." (Laky, 1994, p.30).

[27] Interview with A. Gelei, 25th July, 1997.

[28] Interview with J.Burns, 16th September 1993.

and therefore address inadequately the kind of gaps in information markets highlighted in section 6.1.. Moreover, there appears to be a great amount of duplication in respect of service provision between MVA and other governmental and non-governmental organisations, an issue that will be returned to later in the chapter.

In addition to the problems of duplication and lack of competitiveness of small firms, a further number of constraints have emerged that have provoked a rethinking in respect of the basic support strategy of MVA. In particular, the phasing out of PHARE support has initiated a major rethink, especially as far as financial support schemes and the overall sustainability of the programmes are concerned. Thus, as was highlighted above, the emphasis has in recent policy documents shifted from a discourse on the promotion of SMEs *per se* to a more focused approach on sustaining competitiveness of small and thus (hopefully) ensuring in the process sustainability of the LEAs (MVA 1997). However, whilst the development of competitive SMEs is certainly a laudable goal, it will still require subsidised start-up promotion given the continuing deficit of small firms in high-tech and manufacturing sectors. Given that need therefore, small firm sector development institutions are unlikely to become self-sustainable.[29] However, the MVA strategy document envisages that self-sustainability could be realised through the provision of special services to already established enterprises (MVA 1997). Such an approach, however, risks a diversion of resources from low income/loss-making small firm development towards more lucrative projects with large firms, especially foreign investors. Whilst the promotion of inward foreign investment might be considered to come under the remit of local economic policies, it would require an integrated strategic approach, including possibly a sectoral focus, in order to maximise gains from inward

investment to the local economy balanced with a support of the indigenous small firm sector.

Moreover, the 1997 strategy document remains conveniently vague both in regard to measurable objectives and appropriate instruments. The danger of a mismatch between objectives and scale and scope of instruments therefore remains persistent. Furthermore, MVA has a narrowly defined remit in respect of the operationalisation of small firm policies and is seen to be standing alongside other governmental institutions. The following section explores these institutions in more detail and outlines the nature of linkages between the various layers of governmental support.

Other government institutions

The Hungarian Small Business Administration (*Országos Kisvállalkozás Fejlesztési Iroda* - OKFI henceforth), was founded in 1990 by Decree no 78 of the Hungarian government and was supposedly an independent organisation under the supervision of the Minister of Industry and Trade. Since it was financed out of the state budget and since the relation to the above ministry was only vaguely defined in the deeds of association the independent character of the organisation was questionable.[30]

The function of OKFI was envisaged to be essentially that of a mediator between the government and SMEs, with the aim of aiding the development of an enterprise-friendly environment in Hungary. In connection with that OKFI was entrusted with development of both a medium and a long- term national small firm policy, a draft of which was

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[29] Wilson and Treller (1996) argue that the incidence of self-sustainability of SME support institutions in OECD countries is very rare indeed and the insistence on sustainability by donors in Eastern Europe appears to be wish-driven rather than founded on concrete experience.
[30] Interview with G.Faragó, 28th September 1993.

published in 1993 (Arvay 1993 "Vállalkozásfejlesztés" in *Vállalkozás*, no. 9). Essentially, a division of labour between OKFI and MVA was envisaged, with OKFI being the strategic arm of government policy and MVA the operational one.[31] The strategy report stressed the importance of improving the legal as well as the financial environment in which small firms currently operate, as well as the need for the development of an infrastructure that aids access to information and education for Hungarian entrepreneurs. Thus, OKFI contributed little in the way of firming up the loose objectives outlined by MVA. Furthermore, as a purely strategic arm it did not have any significant resources at its own disposal nor did it have executive powers and was therefore conspicuously silent about the instruments (Arvay 1993, interview with G.Faragó, 28th September 1993). Due to the lack of resources, entrepreneurs also did not perceive any value in an organisation like OKFI and the mediating role was therefore severely constrained.[32] As MVA gained greater importance and a plethora of business support and lobbying institutions mushroomed, OKFI increasingly faded into obscurity until it was, in 1995, renamed the Institute for Small Business Development and placed under the auspices of the Ministry for Industry, Trade and Tourism. Its role is now largely confined to information gathering and analysis on the small business sector, although in conjunction with the Ministry of Industry and the Ministry of Finance it is indirectly participating in the debate on small firm policy design.[33]

In addition, a new institution, the Enterprise Development Council (*Vallákozásfejlesztési Tánacs*) was set up by government decree in 1995 with an advisory remit. It is chaired by the Minister for Trade, Industry and Tourism and includes amongst its membership representatives from relevant ministries, associations,

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[31] Interviews with G.Faragó 28th September and 22nd November 1993.

chambers, entrepreneurial representations and MVA. In its advisory and evaluating capacity it has stressed the need for the development of legislation pertaining to small firms especially in the light of forthcoming EU entry and the perceived need to harmonise legislation in line with EU practice (Schifner and Szalai 1997). However, given the resource constraints of the Council, it is largely dependent on other institutions for the implementation of recommended policy proposals (Ferenczy 1997).

Other governmental institutions that need to be mentioned are the credit guarantee institutions such as Credit Guarantee plc (*Hitelgarancia Rt.*) and the Rural Credit Guarantee Foundation. These institutions with the backing of budgetary sources have been seeking to address the problem of the lack of collateral in enterprises seeking to obtain loan finance. The majority of loan guarantees have been granted to small and very small enterprises with 65 percent of issued guarantees going to enterprises with less than 50 employees. However, only 20 percent of guarantees went to industrial enterprises, with the rest equally distributed between agriculture and food processing on the one hand and trade and services on the other (Kállay et al. 1997). Including 1997, 1,600 enterprises have benefited from loans guaranteed through Credit Guarantee plc, which appears to be a very small amount given the high demand (Kállay et al. 1997).

Summing up Hungarian government policies towards the small enterprise sector, the outstanding feature is the lack of a coherently defined small firm policy embedded in a framework of a wider and deeper industrial policy. Although a number of institutions have been developed, their remit is often ill-defined with responsibilities either overlapping, especially in respect of the provision of certain types of real and financial

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[32] Interviews with G.Faragó, 28th September 1993 and J.Varkonyi, 15th September 1993.

services, or neglected altogether. In the view of some observers, macroeconomic policies that are driven primarily by EU accession considerations do not dovetail with official programmes for government support for SMEs (interview with P.Szirmai, 28th July 1997). The relative inadequacy in *comprehensively* addressing market failures and transition-specific weaknesses becomes apparent. An explanation might be seen in the ideological hostility against interventionist industrial policies that co-ordinate policies at the macro-, meso- and micro-levels towards a commonly defined goal, and in the subsequent appeal and piecemeal adoption of British-style SME policies. The outcome has been a patchwork of institutions, policies and individual programmes that do not constitute an integrated SME strategy. This fragmentation and lack of strategic approach towards the support of small firms can also be seen in the non-governmental sector that will be considered in the next section.

### 6.4. Non-governmental small business support in Hungary - the institutional framework at the national level

The number of institutions involved in small business support outside the governmental sector is growing rapidly. This is due firstly to the decentralisation of existing organisations, for example the Hungarian Chamber of Commerce and Industry spinning-off local chambers. Secondly new organisations, both profit- and non-profit making, have mushroomed alongside the rapid development of the small firm sector and the accompanying 'vogue' for services such as foreign partner finding and legal and financial counselling. A key position in the non-governmental SME support sector is occupied by the various chambers. Following the 1994 Act on Chambers of Economy, three umbrella chambers (the Hungarian Chamber of Commerce and

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[33] Interview with L.Kállay, 30th July 1997.

Industry, the Hungarian Chamber of Artisans and the Hungarian Chamber of Agriculture) were set up which have under their auspices a network of chambers operating at the local level of the Hungarian economy. A novelty of the Act was the introduction of compulsory membership requirement of chambers for Hungarian businesses. It also led to the elimination of some of the smaller chambers that were focused very narrowly on specific types of businesses such as the Chamber for Small and Medium-Sized Enterprises. The Hungarian system thus became very closely based on the German chamber system and the key benefits that were expected to be derived from it included a much broader interest representation as well as sufficient financial means to provide high quality services.[34] As regards the former, the chambers have indeed been actively involved in a broad range of activities framing government policy, including the National Council for Regional Development, the Enterprise Development Council and National Committee for Technological Development, to name but a few (for a comprehensive list see Kállay et al. 1997). The development of a comprehensive and high-quality real service provision, however, has not been unproblematic. From the point of view of the chambers, these service provisions need time to be established especially since there were financial teething problems following the introduction of compulsory membership fees. Hungarian entrepreneurs, on the other hand, reserve a degree of scepticism towards the system since the fees entitle members to basic services with more tailor-made ones attracting additional charges.[35] The introduction of compulsory chamber membership has also affected the development of other real service providers in the non-governmental sector that have seen their client base shrink (interview with L.Kállay, 30th July 1997). Table 6.5. seeks to present an overview (based on interviews with key personnel in the institutions and outside observers) of the

[34] Interview with A.Rezner, 29th July 1997.

most relevant of these institution. The observation of the institutions in the field revealed a number of fundamental problems associated with non-governmental small business support in Hungary. Firstly, the number of business support institutions is large and the organisations cut across sectoral and size categories with frequent overlaps. Hungarian entrepreneurs, wary of the myriad of membership fees and dubious benefits, are often hesitant about joining organisations, thus further limiting the scope of the existing ones. Secondly, the services provided fall mainly into the category of real rather than financial services. However, given the limited resources of most of the institutions, the level of service provision, aside from basic information and business training, is very low and does not adequately address the need for sophisticated information that would enable firms to achieve genuine competitive advantages. Having said that, the introduction of compulsory chamber membership has concentrated resources in the hands of a limited number of institutions, thus increasing the possibilities for the provision of more sophisticated services. However, that requires further significant restructuring, especially in building up the kind of network forms of organisation that have been observed in the German case. These new forms of organisation between entrepreneurs, the third sector and governmental organisations cannot, however, be transplanted overnight, as has been done so conveniently in the case of the legislative and organisational frameworks, but have to develop over time adapting to the particular local conditions.

[35] Interviews with A.Rezner, 29th July 1997, A.Sztanko, 28th July 1997 and G.Bényei, 30th July 1997.

Table 6.5: Small business support institutions in Hungary

| Name of Organisation | Services Provided | Comments |
|---|---|---|
| Hungarian Chamber of Commerce and Industry | • provision of information in particular to start ups<br>• organisation of international fairs and exhibitions<br>• participation in development of relevant information<br>• provision of quality certificates<br>• training<br>• assistance in international trade<br>• issue of certificates and authentication of documents | compulsory membership since revision of law on chambers in 1994<br>significant own resources from membership fees - potential collaboration with MVA discussed but as yet not established |
| Hungarian Chamber of Artisans | • represents professions in international trade, development of legislation and business infrastructure<br>• examination for admission to guilds<br>• legal, economic and commercial advice | as above but for professions |
| Hungarian Chamber of Agriculture | • as above but confined to agriculture, forestry and related services and industry | as above but limited to agriculture and forestry |
| Chamber of Small and Medium-Sized Enterprises | • international partner search<br>• business services (Fax, translation services etc.)<br>• general economic advisory capacity | disbanded in 1994 following Law on Chambers |
| National Association of Entrepreneurs (VOSZ) | • participation in National Conciliation Council (ILO link) representing interests of private entrepreneurs<br>• dissemination of information to members of relevant economic and commercial information | dormant between 1993 and 1994 as president Palotas formed political party to realise aims of VOSZ, resurrected VOSZ in 1994 following its near-bankruptcy |

| | | |
|---|---|---|
| Hungarian Association of Craftsmen's Corporations (IPOSZ) | • facilitation of international business links<br>• lobbying function for private enterprise<br>• provision of business and vocational training<br>• provision of information on business opportunities in Hungary and abroad | represents largely employers interests |
| Hungarian Industrial Association (OKISZ) | • advice on marketing, tax issues, international markets<br>• provision of general business training and vocational training through associated associations | represents largely medium-sized enterprises through affiliated associations with sector-specific focus |
| National Federation of Agricultural Cooperators and Producers (MOSZ) | • interest representation of agricultural cooperatives | have experienced rapid loss of membership due to break-up of cooperative farms and decline in agriculture in general, subsequently influence and importance greatly diminished |
| National Federation of Traders and Caterers (KISOSZ) | • provision of business training for traders and caterers<br>• interest representation<br>• general business advice | federated structure comprising of regional and professional member associations<br>represent largely micro-enterprises |
| Hungarian Small Business Association (MKVT) | • represents small business interests in Interest Coordinating Council and also member of Enterprise Development Council at the Ministry of Industry, Trade and Tourism<br>• provision of general business advice and information | |
| Small Enterprise Economic Development Foundation (SEED) | • promotion of business start-ups of special groups in society in particular young people, women and gypsies<br>• maintenance of links with international donors working in the field | |

| | | |
|---|---|---|
| Business Basics Foundation (BB) | • provision of tailor-made training programmes<br>• business library<br>• study trips and exchanges | strongly influenced by external financing but probably the most focused of the training providers, use of external consultants but only with good command of Hungarian |
| Centre for Private Enterprise Development (SUNY) | • managerial training<br>• research on private sector<br>• development of TQM in enterprises<br>• coordination of scientific assistance programmes to Hungary such as Eureka and Kopernikus | set up by New York State University and later financed through USAID, only gradually focusing attention on small enterprise sector |
| Centre for International Private Enterprise (CIPE) | • research and dissemination of information on private sector development in Hungary<br>• support of business advocacy | part of US Chamber of Commerce and funded through USAID, focuses mainly on macroeconomic policies but has more recently taken interest in local-level policies |
| Hungarian-American Enterprise Fund (MAVA) | • provision of risk capital and active participation in company restructuring (total loans US$ 5 million)<br>• provision of micro-credits (US$ 400,000 credit lines available) | part-Hungarian ownership required but focuses on ventures with foreign participation |

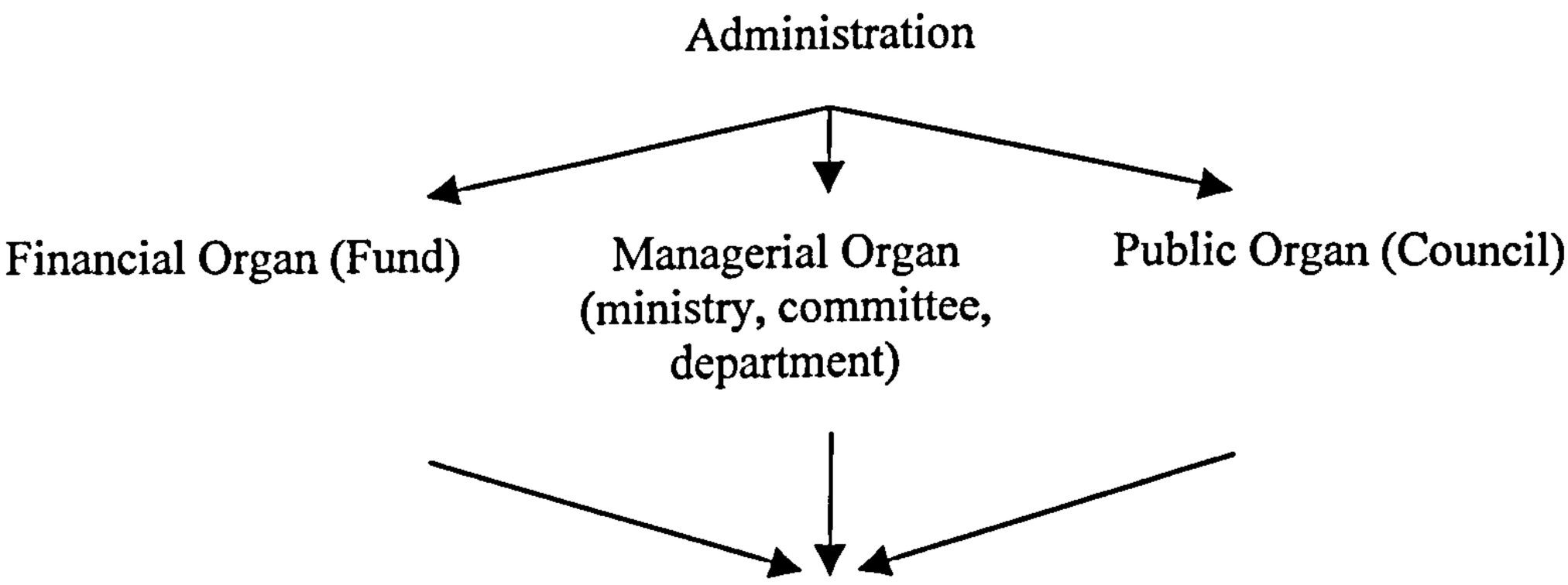
The section has shown that the Hungarian national-level SME policy framework has borrowed to varying degrees from international practice. The following section will analyse the antecedents and the development of small firm policies in the Russian Federation.

## 6.5. Government policies towards SMEs in Russia – the national framework

The development of the institutional framework for SME support in the Russian Federation reflects both the *ad hoc* approach that has characterised much of policy-making at the national level and the Russian obsession with all-permeating bureaucratic structures. During the initial stages of reform, small firm support measures were subsumed in the responsibilities of a number of government departments and ministries. Thus the Antimonopoly Committee of the Russian Federation dealt with small firm sector issues under its remit for developing competition in the economy. The State Committee for Science and Technology sought to promote innovative small firms and the Ministry of Labour tried to develop SMEs as part of its labour market policies. Since these arrangements and structures resulted in a considerable lack of transparency and co-ordination, and since the development of small business and entrepreneurship became increasingly a focal point of structural policies (Pravitel'stvo *RF* 1997), the creation of new institutions was considered necessary. Based on the past experience of government institutions involved in SME support, a structure based on functional responsibilities was proposed (the experience of the Moscow Administration in SME support structures was very influential as it was seen as a very successful one, see Ioffe et al. 1996). The three main components responsible for policy development and implementation are the committee (which at the federal level carries the status of a

ministry) or department, which is largely responsible for policy development, control and co-ordination. The national fund is the financial arm of the structure through which all financial resources will be channelled. Finally, representatives of entrepreneurs will be involved in the decision-making progress through the public arm, which is represented by a council.

Diagram 6.1: Basic components of the SME support infrastructure in Russia



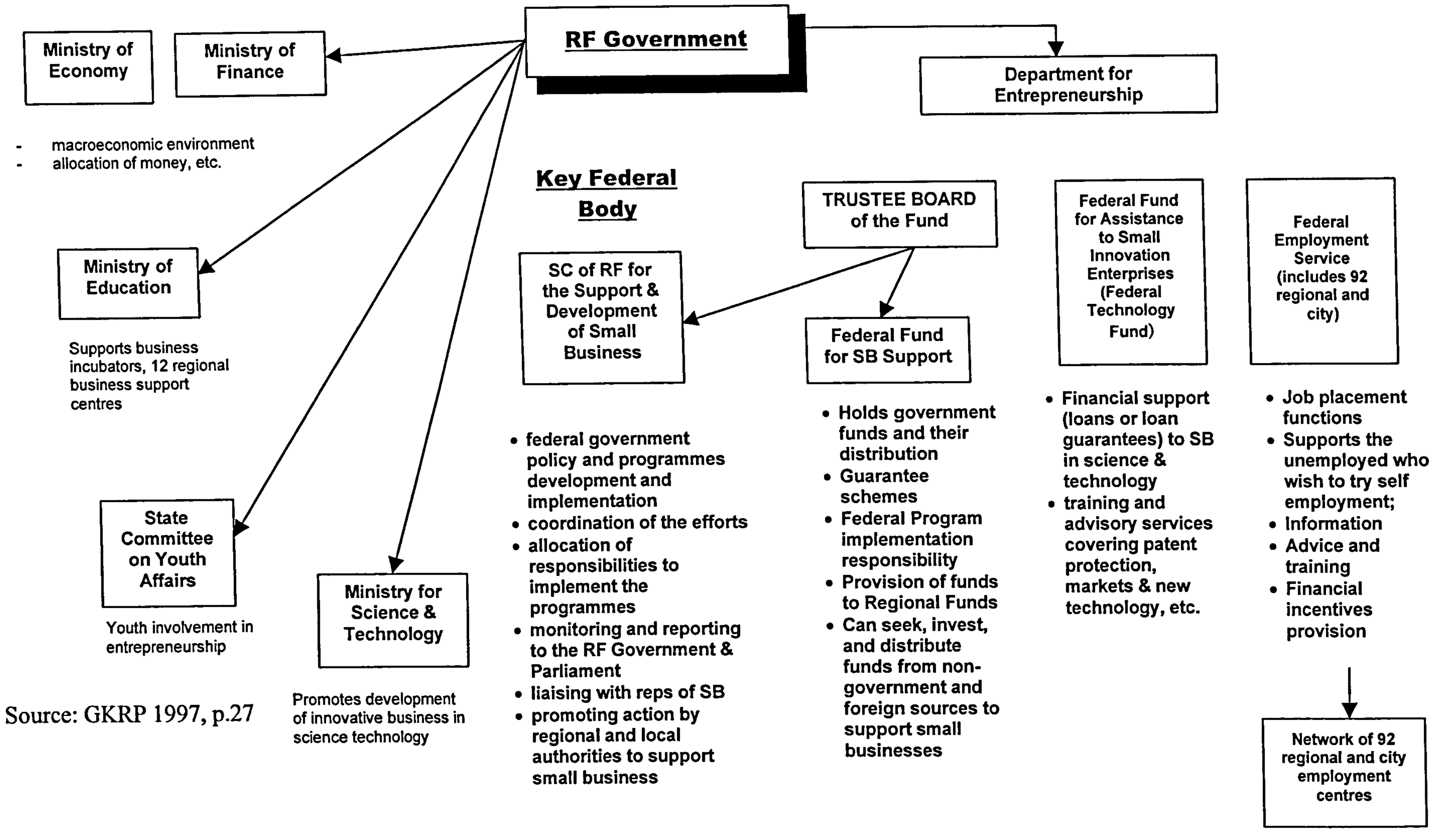

Source: Ioffe et al. 1996, p.161

Thus in 1995, the State Committee of the Russian Federation for the Support and Development of Small Business (*Gosudarstvennyi Komitet Rossiiskoi Federatsii po podderzhke i razvitiyu malovo predprinimatel'stva* - GKRP[36]) was set up as the managerial arm of the small business support system. The Federal Fund for the Support of Entrepreneurship (*Federalnyi Fond podderzhki predprinimatel'stva*[37]) was set up

[36]Presidential Decree No. 563, 6th June 1995 *O Gosudarstvennom Komitete Rossiiskoi Federatsii po podderzhke i razvityu malovo predprinimatel'stva*' and Decree of the Government of the Russian Federation no. 1045, 28th October 1995.
[37]Decree of the Government of the Russian Federation no.1184, 4th December 1995 *O Federal'nom Fonde podderzhki predprinimatel'stva.*

alongside as the financing arm, and a board of trustees was appointed that oversaw the activities of these institutions. This process of institution-building was seen as marking the first stage in the development of a comprehensive national policy framework (interview with V.Pimoshenko, 23rd November 1995). However, although the new structure was intended to assume all responsibilities for SME support, other governmental departments continued their own activities in that area as diagram 6.2. shows.

Diagram 6.2: Government institutions involved in state support for SMEs




Source: GKRP 1997, p.27

As diagram 6.2. shows, the original idea of streamlining and co-ordinating government department's activities in the field of SME support actually resulted in adding new layers of bureaucracy. Ministries and departments, fearing the erosion of their power base, clung on to various responsibilities in the field of SME support which, given the priority status attached to it by the government in economic policy documents (Pravitel'stvo RF 1997), promised to be a lucrative area of involvement.[38] There are, however, no clearly defined functional or organisational boundaries that would justify the existence of these layers and the division of labour continues to be arbitrary and blurred. Furthermore, the question arises whether the myriad of institutions is efficiently co-ordinated so as to increase the effectiveness of SME policies. As Blinov argued succinctly:

> An appropriate State Committee of the Russian Federation for the support and development of small entrepreneurship has been set up, laws have been passed, decrees signed, through resolutions of the government, congresses take place, conferences, 'round tables',.... And what else?! (Blinov, 1997, p.39, own translation)

Although an institutional framework for the support of small business was put in place, government policy towards the small enterprise sector lacked a coherent strategy with aims and objectives vaguely defined and instruments being weak due the lack of financial support from the centre (Ioffe et al. 1996). For example, even though the financial resource base for SME support at the federal level was somewhat expanded after the passing of the 1994-1995 Federal Programme of State Support for SMEs (Anon 1994), of the envisaged funding of 210 billion roubles for SME support

measures, only about 10 percent of it, or 0.001 percent of total budgetary expenditure, was actually being allocated and that largely towards the end of the programme(OECD 1998).[39] Furthermore, the programme was highly selective focusing largely on the implementation of pilot projects that were problematic due to the potential for rent-seeking and the lack of value-added. The disembedded nature of federal-level SME support was confirmed in the survey by the Russian Independent Institute for Social and Nationality Problems which showed that only 12.6 percent of the polled firms were aware of any kind of federal support programme, and only 5.3 percent had received any kind of assistance from the federal government (Avilova et al. 1996).

The 1996-1997 programme was a more elaborate programme inasfar as it sought to define principles, outcomes and instruments as has been summarised in table 6.6..

[38] Interview with A.Chepurenko, 20th November 1995.

[39] Given the high-inflation environment, this would reduce the real value of the financial resources.

Table 6.6: The 1996-1997 State Programme for SME Support

| Outcomes | Principles | Instruments (projected funding in billion roubles) |
|---|---|---|
| 2.5-3.5 million small firms | • Greater emphasis on regional-level programmes for funding | • share funding of regional projects (140)<br>SME support in the regions for emergency situations (20) |
| 30 million employed in small firms | • Transition from pilot projects to comprehensive infrastructural development | • Leasing promotion fund (120)<br>• Information networks (28)<br>• Educational and Training Programmes (1)<br>• Business Security Systems (0.2) |
| 2-fold increase in SME contribution to GDP | • shift from direct SME support to establishment of guarantee fund for SME credit lines<br>• transition from Federal funding to variety in funding resources<br>• linking SMEs to large organisations | • Risk capital fund for investment loans (25) |

Source: Ioffe et al., 1996 and OECD 1998

However, as in the preceding programme, the projected amount of funds needed for the implementation of the programme (estimated at 0.16 percent of Federal expenditure in 1996- Ioffe et al. 1996) was unlikely to be forthcoming as the budgetary crisis worsened and Duma deputies tended to vote in favour of programmes that were competing for

funding with the SME projects. Also, part of the monies for SME support was supposed to be coming from privatisation revenues[40], which fell short of projections (OECD 1997).

While it is problematic to assess the effectiveness of the programme, given the still unclear situation regarding inputs and the absence of data on output, we can nevertheless make some observations regarding the relative appropriateness of these policies. Firstly, there is a significant mismatch between the projected inputs and the expected outcomes. The expected outcomes, even allowing for a certain multiplier effect, are quite unrealistic, particularly given the overall dynamics of the Russian economy on the one hand (considering the aftermath of the Russian crisis included a further tightening of budgetary purse strings) and the limited resources committed by policy-makers on the other. The outcomes are strongly reminiscent of *gosplan*-style central planning whereby a central institution seeks to achieve quantitative growth targets by increasing the resources made available. The instruments, however, appear to be eclectically drawn from Western SME programmes. Moreover, there is an implicit assumption that an increase in the numbers of SMEs will lead to a proportionate increase in employment. As Storey (1994) has shown, this assumption is not borne out by any empirical evidence. The expected increased contribution of SMEs to GDP is also ambiguous since it might materialise through a contraction in GDP (as has occurred in 1998) rather than increased activity of the SME sector.

The principles of the programme, however, reflect a number of positive developments. There is first of all a recognition, given regional diversity, of the need for greater

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[40] A decree passed by Yeltsin stipulated that in 1996 the Federal Fund should receive 5% of privatisation

decentralisation of policies to the regional level. Furthermore, the planned transition from selective intervention in the form of pilot projects to comprehensive infrastructure development should reduce the scope for rent-seeking activities. Diversification of funding sources and establishment of large firm-small firm linkages are also sound principles. Yet, the programme is rather vague on the operationalisation of some of these principles, especially regarding the development of linkages and diversification of funding. Lastly, the programme lacks an effective system of monitoring that would enable policy-makers to assess resource utilisation and measure the relative success. This is a particularly critical issue in the Russian case where accusations of money laundering and misuse of governmental and international donor funds have been rife in 1998 (*The Economist*, 28th August 1999).

Despite these shortcomings, the programme leading up to the year 2000 calls for even more unrealistic outcomes, including the development of 3-5 million functioning small enterprises which will employ approximately 40 to 50 million people and contribute between 30 and 40 percent to GDP. The resource base has, at the time of writing, not been defined.[41] Thus, although bureaucratic structures and various piecemeal programmes are in place, Russia is still lacking a strategic government policy towards SMEs. The question arises as to whether the non-governmental sector and international donors (which have by and large bypassed the state institutions) can address some of market failures outlined in section 6.2.

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revenues that were estimated to be around Rb 707 billion (OMRI Daily Digest I, 9th April 1996).

[41]Indeed, following the August 1998, Russia has seen three successive governments so far which seriously undermined attempts at coherent economic policy-making. The Primakov government, according to press reports, advocated a stronger role for government intervention in the economy, attempts which were subsequently undermined by crisis management and the sacking of two governments in a row.

## 6.6. Non-governmental business support in the Russian Federation

Aside from governmental structures and policies, there is also a growing network of non-governmental institutions involved in SME support. Amongst these are, on the one hand, Russian small business self-organisations and, on the other, institutions and programmes funded through international technical assistance programmes. In resource terms, the international donor effort overshadows government support programmes for SMEs. Table 6.7. provides an overview of the activities of international donors in the field of Russian SME support.

Table 6.7: Internationally-sponsored SME support in the Russian Federation

| Name of Donor | **Institutional Framework** | **Services Provided** | **Comments** |
|---|---|---|---|
| United States Agency for International Development (USAID) | 8 regional support centres<br>144 units of technical support for SMEs<br>19 business incubators | • business training<br>• information, advice and consultancy for small businesses<br>• support for trade fairs<br>• research on business-related issues<br>• dissemination of information through publications<br>• advice to local authorities on small business support | • link with US NGOs such as Peace Corp<br>• collapse of centres as USAID withdrew funding in 1997 |
| EU Tacis | • network of Small Enterprise Development Agencies (SMEDAs) and Enterprise Support Centres (ESCs)<br>• establishment of Regional Venture Funds with EBRD | • provision of real services (information, training, consultancy) | • priority area of EU technical assistance in Russian Federation<br>• promotion of 'local ownership' of centres through working with but not for local governments<br>• sustainability of centres questionable once EU funding withdraws<br>• regional coverage not comprehensive |
| EBRD | • Regional Venture Funds with Tacis<br>• Russian Small Business Fund | • financial services (small loans, microcredits, small equity)<br>• business advisory and training alongside financial services | • $150 million from G7 and $150 million from EBRD ordinary capital resources<br>• financial resources channelled through local banks which receive intensive training in SME lending<br>• regional coverage incomplete |
| UK Know-How Fund | • Assistance to 8 Russian Technoparks (with TACIS)<br>• Centre of Excellence at Academy of the National Economy | • provision of real services to enterprises (training)<br>• policy-advice to governmental structures at the federal and regional levels | • commitment of £10 million in various projects |
| Far East Programme of MITI (Japan) and State Monopoly Committee of RF | • International SME Policy Centre, Far East Foundation and 4 Technological Centres | • policy advice, training of Russian SME policy-makers in Japan, information exchange, equipment supply to technological centres | • concentration on Russian Far East |

Additionally, there are a number of technical and financial assistance programmes financed by international organisations such as the World Bank, the Kreditanstalt für Wiederaufbau or Eurasia Foundation that have provided services, both financial and non-financial, to Russian SMEs.

As regards the impact of international donor assistance to Russian SMEs, assessments of effectiveness are hindered by the lack of monitoring and evaluation of programmes. However, a number of observations can be made. Firstly, the programmes are by and large divorced from governmental policies for SME support and were aiming to bring about a private sector 'demonstration effect' which impacted upon the development of the firms supported but had only a marginal effect on local economic development (Tsantis 1998). Secondly, many of the programmes have concentrated resources on institution building and the development of programmes, but experience so far suggests that the potential for self-sustainability is limited (Wilson and Treller 1996). Furthermore, because of the emphasis on institution-building, the actual assistance rendered to small firms is often modest (Avilova et al. 1996). Thirdly, the regional coverage of international assistance is uneven and a lack of co-ordination between donors has resulted in overlapping initiatives, as in the case of the Tula region which was highlighted in an OECD report (OECD 1998). Lastly, many of the international assistance programmes have been plagued by so-called 'consultant fatigue' whereby foreign experts (on high fees) develop programmes that are based on Western experience with little regard to local conditions and specificities (Pautola 1996, Wedel 1998).

In addition to the international donor effort, there are also an increasing number of national-level Russian entrepreneurial associations, unions and chambers involved in

SME support. Diagram 6.3. illustrates the involvement of the main business organisations in Russia.

The impact of these organisations on Russian SME development is, however, limited. Entrepreneurs are reluctant to join associations as they are sceptical about the ability of organisations to deliver services to them.[42] The survey by the Russian Independent Institute of Social and Nationality Problems cited above showed that only 3.9 percent of respondents received any real assistance from associations. The resulting low participation rate in self-help organisations (OECD 1998) reduces their income and further limits the ability to deliver services. The absence of compulsory membership of chambers reduces their role and forces them to compete with other associations for members.[43] The owner of a private law firm argued that the type of legal services, for example, that are provided by the chambers, tend to be given by 'all-round experts' who lack sufficient in-depth knowledge of sector-specific problems.[44] A key function of the business organisations, political lobbying, is impeded through the lack of efficient lobbying mechanisms and the high degree of fragmentation exacerbated by often exclusive functional, sectoral, gender and religious focus of the associations (OECD 1998). Although non-governmental organisations are addressing some of the needs of the emerging small firm sector, they are not able as yet to fill the vacuum created by the absence of strategic government intervention.

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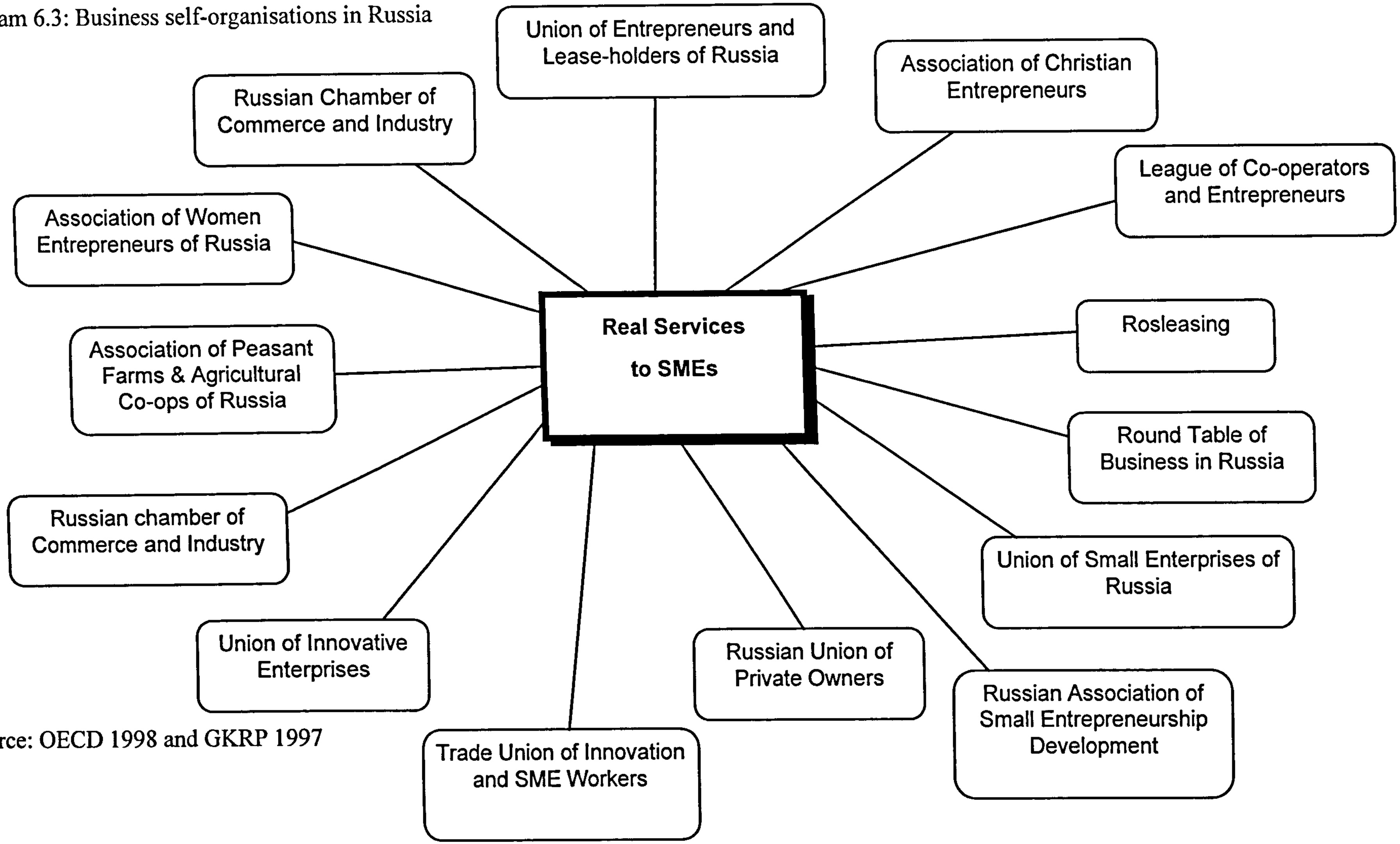
[42] Interviews with Y.Malykhin, 15th April 1994, L.Gofman 20th April 1994.
[43] Interview with A.Muryanov, 23rd November 1995.
[44] Interview with B.Nikolaev, 15th April 1994.

Diagram 6.3: Business self-organisations in Russia




Source: OECD 1998 and GKRP 1997

The evidence that has been presented suggests that although the government has in its rhetoric embraced the concept of small firm policy, there is little in the way of a constructive, strategic approach to SME development at the federal level in Russia. International donors and small business self-help organisations have sought to address some of the problems of the Russian small firm sector. Yet, they too lack strategic focus and long-term financial sourcing. One of the most notable developments in Russian SME support is the proliferation of institutions involved in SME support with often overlapping programmes resulting from the lack of co-ordination and transparency. Similar to the Hungarian case, macroeconomic policies focus very narrowly on short-term stabilisation objectives and do not create the kind of macroeconomic environment in which small firms can thrive. Real assistance delivered to small firms is very modest and the overwhelming majority of SMEs rely on self-help and informal networks for their survival.

## 6.7. Conclusion

This chapter has considered the development of small firm policies at the national levels in Russia and Hungary. The rationale for government intervention has been demonstrated by analysing the evidence of market failures and the distortionary effects of government intervention in respect of the creation of compliance costs. In both countries, there is evidence of significant barriers to small firm development although the scale and scope of barriers to entry and development are greater in the Russian Federation. The roots of that can be seen to lie in the peculiar Russian historical conditions as well as the slow and tumultuous transition path. However, aside from these 'arguments from principle' for government intervention, there are

also persuasive pragmatic reasons for government intervention. These relate largely to the *expected* positive externalities generated by a well-developed small firm sector. In the Russian Federation, furthermore, political considerations hold sway with policy-makers when arguing the case for government intervention.

The second part of the chapter has looked at the development of national-level frameworks for SME support, both governmental and non-governmental. The Russian example here departs very significantly from the Hungarian one in a number of respects. Firstly, Hungarian small firm policies have, since their inception, been strongly influenced by Western models. The organisational make-up of the network of local enterprise agencies borrows strongly from the British model[45] as do MVA policies in terms of their approach towards achieving policy objectives. The development of a system of chambers to back-up government programmes based on compulsory membership, however, borrows strongly from the German model. Thus, there is a strong tendency to import 'best practice' from abroad, a trend that is driven by the influence of international consultants, by the proximity to EU countries and by the preparation for full EU membership with its condition of compliance with the acquis. However, the replication of these models in the Hungarian context cannot be considered to have been successful as they failed to address the particular weaknesses of Hungarian small firms. Moreover, the defects of Western policies, in particular British ones, in respect of lack of objectives and strategic outlook, have also been taken on board as has the neo-liberal philosophy underlying policy-making (Bateman 1999).

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[45] A difference lies, however, in the direction of development. In the UK, local enterprise agencies were essentially the product of bottom-up development whereas in Hungary, very few of the LEAs were based on genuine local initiatives but developed rather in response to the top-down MVA initiative. Chapter 7 examines this issue from the perspective of two Hungarian localities.

Russia, on the other hand, has sought to develop its own brand of policy-making that is strongly reminiscent of *gosplan*-style planning. The key focus of the government in the SME policy field has been on institution building in a tightly-controlled top-down process. The outcomes of programmes have been strictly and narrowly defined and assume significant multiplier effects. Given the paucity of resources on the one hand and the application of those in ways that only narrowly add value (i.e. selected pilot programmes), none of the objectives that were set have been achieved thus far.

There are, however, broad similarities between the two countries' small firm policies at the national level. Firstly, although the words strategy and strategic are frequently used in the discourse on policy by Russian and Hungarian policy-makers, the evidence suggests that the policies in both countries do not tend to be proactive. In Hungary, this is the product of design, as essentially 'laissez-faire'-type policies have been imported. In Russia, on the other hand, it is more the result of default as economic policy-making is increasingly turned into a crisis management activity and small firm policies, despite rhetorical indications to the contrary, have not attained the same level of importance as stabilisation and privatisation policies. The second similarity relates the particular forms of organisations that are emerging. In both countries, there is a strong trend towards the development of hierarchies. The development of policies and institutions is largely top-down and boundaries between actors, whether they are governmental departments, non-governmental organisations or entrepreneurs, are hard and clearly defined. When networking occurs, it is mainly at the level of personal networks and, as is the case in Russia, forms part of survival strategies in the face of hostile external conditions. Lastly, in both countries, policies have been devolved to the local level albeit through varying mechanisms and to

different degrees. The next chapter looks at small firm policy from the perspective of localities in Hungary and the Russian Federation.

# Chapter 7: Local-level policies for small firm development: Case studies from Hungary and the Russian Federation

The preceding chapters have analysed the size and structure of the Hungarian and Russian small firm sectors as well as the policies developed at the national levels, in both countries, in support of the sector. This chapter seeks to shed light on the developments of small firms and small firm policies at the local level in the two countries by means of case studies. Such developments and policies, however, must be assessed in the context of regional disparaties in Hungary and Russia as these, a priori, can have a significant impact on the development of small firms (Batkilina and Skameikina 1994, Sutherland 1996). Thus the analysis will seek to determine such influences.

The first section starts by highlighting the nature of regional differentiation in Hungary and Russia and briefly outlines the main factors that have influenced uneven regional development. Furthermore, the extent to which small firm sector development mirrors the trend towards uneven regional development in the two countries will be examined. The following sections will analyse small firm development and small firm policies at the local level in Russia and Hungary by looking at four case studies – Szabolcs-Szatmár-Bereg (SSB) and Budapest in Hungary, and Moscow and Tyumen in the Russian Federation. The case study analysis highlights the different dynamics of small firm development at the local level within and between the two transitional economies and seeks to explain these differences by analysing the factors that contribute to or stymie the growth of SMEs in these regions. Furthermore, the case studies will describe how policies at the local level in the two countries have evolved and to what extent they are tailored to the needs of the small firm sector in the locality. In other words, the research will seek to assess how appropriate these policies at the local level are, taking into account the degree of broader value-added of such policies.

## 7.1. Regional development in Hungary and Russia compared

### 7.1.1. Spatial variations, regional development and SMEs in Hungary[1]

The historically uneven spatial pattern of economic development in Hungary has, after a period of slight mitigation under central planning (Barath and Szalo 1990), seen a return during the transitional years. Whilst in the traditionally prosperous regions west of the river Danube, unemployment has remained modest (KSH 1997), the rural East of the country has been deeply affected by structural reforms resulting in stagnating incomes and persistently high unemployment rates (Horvath 1995). One observer spoke of a country "...split into two entrepreneurial cultures." (interview P.Szirmai 28th July 1997) that cannot simply be alleviated by pumping money into the poorer East. This historical East/West divide is not, however, the only pattern of regional disparity that can be observed in Hungary. A more prominent distinction has emerged in respect to Budapest and its surrounding region considerably outperforming the rest of the Hungarian regions (KSH 1997). Central planning sought to alleviate this centre-periphery distinction through the location of industrial activities outside the capital, yet these policies have served to reinforce the current trends, as manufacturing has suffered heavily during the transitional recession (OECD 1996, Horvath 1993 and 1995). In addition to the East/West divide and the strong radial pattern of development, uneven localised economic development can be discerned where, for example, western regions suffer similar problems of peripherality to eastern parts (Horvath 1996), or where there are enclaves of recession in otherwise prosperous parts because of the presence of mono-industry towns (OECD 1996).

A number of factors can be identified that have shaped these patterns of regional diversity in Hungary. As already indicated, policies under central planning aimed at

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[1] See appendix 2 for a map of the Hungarian regions.

forced industrialisation outside the core regions have backfired as industries lacking competitive advantage in their plan-led location have folded in a market-driven environment. Secondly, the physical infrastructure and, in particular, the radial pattern of the rail and road networks have reinforced the centre-periphery disparities and have especially disadvantaged the eastern regions where the infrastructural provision is very low (Faragó 1995). Reorientations of trade patterns, with falling trade shares with the countries of the former Eastern bloc and closer integrative ties with EU countries, have impacted on uneven regional development. Regions that benefitted from changing trade patterns were those with close geographic proximity to the European Union markets. The eastern regions, however, that were traditionally sustained through trade with the former CMEA countries, suffered from this development. A more long-lasting influence on regional disparity is likely to occur through foreign direct investment, which is strongly spatially imbalanced, focusing largely on the towns of Györ and Szekesfehervar west of Budapest. The regional development impact of FDI is likely to be strengthened as local clusters of suppliers develop around the foreign plant.[2] Of course, failure to embed the activities of the foreign multinational into the local economy could also have adverse effects as multinationals are notoriously footloose and might relocate if local conditions cease to be favourable.

In the light of these stark regional disparities the question of the role of small firms in the promotion of indigenous regional and local economic development assumes critical importance. The following paragraphs review the regional dimension of SME development in Hungary.

Regional distribution of SMEs is uneven throughout the Hungarian counties. The core region of Budapest accounts for almost 30 percent of all active enterprises in Hungary and also leads the trend as regards the development of SMEs (KSH 1999). The

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[2] Interview with C.Ivanyi, 23rd July 1997.

following table further illustrates the regional dimension of SME activity by looking at the number of companies per 1,000 population, a variable practically determined by the number of SMEs since population figures can be taken as fairly static. The table also distinguishes simply registered and economically active companies as this gives an indication of the degree of 'phantom' companies in the regional distribution of SMEs in Hungary.

Table 7.1: Number of registered and operating enterprises per 1,000 inhabitants by county in 1996

| | **Registered Units** | | | **Operating Units** | | |
|---|---|---|---|---|---|---|
| | **legal entities** | **sole proprietor** | **total** | **legal entities** | **sole proprietor** | **total** |
| Budapest | 69 | 105 | 174 | 51 | 54 | 105 |
| Bács-Kiskun | 23 | 67 | 90 | 18 | 46 | 64 |
| Baranya | 28 | 75 | 103 | 22 | 45 | 67 |
| Békés | 15 | 60 | 75 | 12 | 43 | 55 |
| Borsod-Abaúj-Zemplén | 18 | 46 | 64 | 14 | 31 | 45 |
| Csongrád | 28 | 76 | 104 | 22 | 51 | 73 |
| Fejér | 23 | 69 | 92 | 18 | 42 | 60 |
| Györ-Moson-Sopron | 24 | 70 | 94 | 20 | 50 | 70 |
| Hajdú-Bihar | 19 | 54 | 73 | 16 | 39 | 55 |
| Heves | 14 | 57 | 71 | 11 | 42 | 53 |
| Jász-Nagykun-Szolnok | 15 | 52 | 67 | 13 | 37 | 50 |
| Komárom-Esztergom | 26 | 64 | 90 | 19 | 45 | 64 |
| Nógrád | 16 | 44 | 60 | 12 | 33 | 45 |
| Pest | 26 | 70 | 96 | 21 | 48 | 68 |
| Somogy | 21 | 106 | 127 | 17 | 49 | 66 |
| Szabolcs-Szatmár-Bereg | 15 | 50 | 65 | 13 | 37 | 50 |
| Tolna | 18 | 74 | 92 | 15 | 45 | 60 |
| Vas | 17 | 65 | 82 | 14 | 42 | 56 |
| Veszprém | 20 | 85 | 105 | 15 | 47 | 62 |
| Zala | 24 | 89 | 113 | 19 | 53 | 72 |
| **Average** | **30** | **73** | **103** | **23** | **45** | **68** |

Source: KSH 1997 as quoted in Kállay 1997, p.9

The table highlights a number of trends as regards the regional dimension of Hungarian SME activity. As already noted in chapter 5, there are substantial differences in the

number of registered companies and those that are economically active, indicating the presence of a large percentage of 'phantom' companies. When looking at the numbers of active sole proprietors per 1,000 population, the regional disparities outlined above can easily be traced. Out of the 11 counties that score above the Hungarian average, only two fall east of the traditional Danubian divide, yet can nevertheless be regarded as central rather than eastern regions. Out of the regions west of Budapest, only Vas and Fejér counties have below average levels of SME activity. In the latter, the absence of SMEs can be considered problematic in the light of the significant FDI that has gone into the region without apparently, as yet, being able to influence (to any substantial extent) local supply companies. The relative lack of SME activity in the Eastern counties suggests that small firms are not as yet filling the gaps left by structural reforms and decline of the large firm sector in the hardest-hit areas.

Looking at per capita GDP in relation to SME activity, a strong correlation can be found (KSH 1999). The core central regions with the highest per capita GDP have also the highest level of small firm activity, a trend that is atypical with international comparisons where high income countries usually exhibit a growth in firm size and a decline in the number of establishments (Kállay 1997). However, in the context of transition economies in general, and Hungary in particular, these developments can be explained in the light of ongoing evolution of a small firm sector that has not yet reached a point of maturity (Kállay 1997).

What emerges from the above is that small firm development in Hungary exhibits considerable regional variations but corresponds closely to the regional disparities that were analysed above. Thus, small firm development has important local dimensions and influences. In order to promote SMEs effectively, those regional and local factors need to be taken into account when devising policies and this will be returned to in the case studies later on in the chapter. The next section will look at the extent to which regional differentation has occured in the Russian Federation, a country vastly greater in territory

than Hungary, and where one can expect an even greater degree of divergence between the regions.

### 7.1.2. Economic divergences, regional development and SMEs in the Russian Federation[3]

The Russian Federation is made up of 89 federal subjects[4], including 21 ethnically defined republics, 49 regions (*oblasti*), one autonomous region, six territories (*kraya*), two federal cities (*goroda*) and 10 autonomous areas (*okrugi*). Following the collapse of the Soviet Union, economic divergences between the regions, once glossed over by strong centralised power and intervention, have become increasingly evident (Sutherland and Hanson 1996). During the 1980s and at the beginning of reforms in the 1990s, the range of inter-regional differences in per capita nominal income decreased: to 30 percent in 1990 and 20 percent in 1992. In 1994 it again exceeded 30 percent (Bylov and Lavrov 1996). There are today marked differences both in terms of growth rates of the Russian regions and of per capita income (see table 7.2.). Even when taking into account price differences between the regions[5], the stratification of 'rich' versus 'poor' regions is marked. The regions with high per capita purchasing power comprise the city of Moscow and resource-rich regions with high export potential (Russian European Centre for Economic Policy 1997). Also included in that category are regions such as Belgorod and Ulyanovsk where income purchasing power has been upheld through the implementation of social policies involving massive fiscal transfer (Bylov and Lavrov 1996, Bradshaw et al. 1998). The 'poor' regions on the other hand comprise the less-developed regions of the North Caucasus and Southern Siberia as well as regions that have experienced rapid decline of their traditional industries such as the textile and

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[3] See appendix 3 for an administrative map of the Russian Federation.

[4] Including Chechnya.

[5] The Federation Treaty of 1992 as well as the subsequent power-sharing agreements between the centre (Moscow) and the regions endowed regional leaders with some discretionary powers over price controls in their regions. Whilst, by and large, supportive of Russia becoming a market-type economy, the attitude of the regional leaders towards often socially painful reforms has been described by Hanson (1994) as "NIMBY" or "Not In My Back Yard". Thus, one source of price differences is the continued control over prices exercised at the regional level.

some engineering regions (Bradshaw et al. 1998, Russian European Centre for Economic Policy 1997).

Table 7.2: Typology of Russian regions by the level of growth rates and per capita nominal income in 1990-1995

| | **Growth rates** | | |
|---|---|---|---|
| | **High (above 110% of Russian average)** | **medium (from 90% to 110% of Russian average)** | **Low (below 90% of the Russian average)** |
| **Income** | | | |
| **High(above 120% of Russian average)** | Moscow city, Murmansk, Kemerovo, Tyumen, Irkutsk, Kamchatka, Magadan, Krasnoyarsk, Karelia, Sakha-Yakutiya | St.Petersburg, Archangelsk, Amur, Khabarovsk, Komi | Orel, Novosibirsk, Tomsk, Sakhalin, Primorskii, Kalmyk |
| **Medium (from 80% to 120% of Russian average)** | Vologda, Sverdlovsk, | Novgorod, Tula, Yaroslavl, Samara | Pskov, Bryansk, Kaluga, Moscow, Ryazan, Kirov, Nizhnii Novgorod, Belgorod, Lipetsk, Astrakhan, Volgograd, Saratov, Rostov, Chelyabinsk, Omsk, Kaliningrad, Stavropol, Altai, Buryat |
| **Low (Below 80% of Russian average)** | Perm | Kostroma, Kurgan, Chita | Leningrad, Vladimir, Ivanovo, Smolensk, Tver, Voronezh, Kursk, Tambov, Penza, Ulyanovsk, Orenburg, Krasnodar, Mari El, Mordova, Chuvash, Tatarstan, Dagestan, Kabardino-Balkarian, North Ossetian, Bashkortostan, Udmurt, Tuva |

Source: Bylov and Lavrov 1996

A number of factors have influenced economic divergences between the regions. Firstly, a key determinant of income growth in the regions has been the inherited economic structure. Thus regions characterised by uncompetitive industrial and agricultural sectors have experienced significant decline (Sutherland and Hanson 1996) whereas regions endowed with natural resources that can be sold on world markets have outperformed the Russian economy as a whole. However, the legacy of uncompetitive sectors is not sufficient for explaining economic performance. Thus Moscow, for example, has experienced one of the sharpest contractions in its industrial sector and has

nevertheless emerged as one of the regions with highest per capita incomes and growth (Bradshaw et al. 1998, Shulyakovskaya 1998). Therefore, the *ability* to initiate industrial restructuring appears to be significant in explaining variations in economic performance across the region. This ability to initiate structural reforms is in turn influenced by the level of investment, including foreign direct investment, the emergence of new economic activities, including service sector enterprises, and small firms and regional government policies (Brown 1993, Hanson 1994, Bradshaw et al. 1998, Batkilina and Skameikina 1994). A last determinant, already noted, are protectionist policies at the regional level in respect of employment and social welfare that have, rather than addressing structural change, managed to maintain the *status quo* (Russian European Centre for Economic Policy 1997). In the long run, such strategies are unlikely to be sustainable and there is a need to deal with structural change at the local level. One of the key elements of that is small firm sector development which not only addresses sectoral issues but also size imbalances inherited from under the old system.

SME development in the Russian Federation exhibits notable regional variations, with significant concentrations in the Central areas, particularly Moscow city, the Urals and Western Siberia (see tables 7.3. and 7.4.). A strong correlation is evident between the numbers and relative weight of SMEs and per capita income in the Russian regions. Although there is some distortion due to variations in price levels, the high income regions (raw material regions and Moscow) also have a high density of SMEs in comparison to the Russian average. However, as was shown in chapter 5, even regions with a high share of SMEs lag considerably behind regions in the European Union and other transition economies in terms of density of SMEs. This is a reflection of the low rates of SME growth in the Russian Federation as a whole.

Table 7.3: Regional structure of SMEs in the Russian Federation

| | **Share in total numbers of SMEs in 1996 (%)** | **Share of total employment in SMEs in 1995 (%)** |
|---|---|---|
| Russian Federation | 100 (877,276) | 100 (8,944,800) |
| Central district<br>*of which* Moscow city | 30.5<br>20.0 | 27.9<br>15.5 |
| Northern district | 2.9 | 3.5 |
| Northwestern district | 9.6 | 7.7 |
| Volgo-Vyatskii | 2.9 | 4.3 |
| Central Black Earth district | 2.7 | 4.2 |
| Povolzhskii district | 9.6 | 10.0 |
| North Caucasus district | 9.8 | 9.7 |
| Urals district | 10.6 | 11.0 |
| Western Siberia | 10.5 | 10.7 |
| Eastern Siberia | 5.2 | 4.8 |
| Far Eastern district | 5.0 | 5.5 |

Source: Vilenskii 1996, p.31 and OECD 1998, p.138-140, own calculations

Table 7.4: Small enterprise output by economic branch in the Russian regions in 1995 (in percent)

| | Industry | Agriculture | Construction | Retailing | Supply and sales |
|---|---|---|---|---|---|
| Russian Federation | 100 | 100 | 100 | 100 | 100 |
| Northern district | 5.4 | 2.4 | 4.8 | 3.5 | 2.9 |
| Northwest district | 7.2 | 3.1 | 7.2 | 12.5 | 10.0 |
| Central district<br>of which Moscow | 27.4<br>11.9 | 19.2<br>5.9 | 28.2<br>15.9 | 19.8<br>6.9 | 26.5<br>9.5 |
| Volga-Vyatskii | 3.7 | 3.9 | 3.8 | 3.4 | 5.1 |
| Central Black Earth | 4.6 | 1.3 | 4.7 | 2.8 | 2.5 |
| Povolzhskii district | 10.4 | 10.6 | 9.1 | 10.8 | 4.0 |
| North Caucasus | 7.0 | 13.1 | 7.1 | 5.3 | 7.3 |
| Urals district | 13.3 | 26.5 | 12.2 | 20.0 | 26.0 |
| Western Siberia | 8.3 | 4.8 | 12.5 | 10.5 | 9.6 |
| Eastern Siberia | 4.4 | 3.7 | 4.1 | 5.9 | 2.9 |
| Far Eastern district | 7.1 | 10.9 | 5.9 | 3.7 | 2.9 |

Source: Adapted from OECD 1998, pp.141 and 142

The regional output data of SMEs in table 7.4. confirm the leading position of the central areas, especially Moscow city, and some of the resource-rich regions in the Urals. However, the resource-rich regions in Western and Eastern Siberia, despite accounting for a relatively high share in the numbers of SMEs, rank lower in terms of SME output. In order to explain that phenomenon, a closer look at the developments at

regional level will be taken in section 7.4. where the Tyumen *oblast'* will be examined. Overall, there appears to be evidence to support the argument that SMEs can act as an important agent of structural change at the regional level (see also chapters 4 and 5). Moreover, high per capita income appears to act as a pull-factor to SME development as opportunities for trade and service-related activities open up. This trend will be further explored in the case studies.

The preceding sections have shown that regional economic divergences have deepened in both countries during the transition period. Influential factors in shaping regional differences include the inherited economic structures and locations as well as the ability to initiate structural change. The latter can often be crucially influenced by governments at the local level, both positively or negatively. It was also shown that the development of small firms closely mirrors regional divergences, with the more successful regions generally exhibiting a greater density and relative weight of SMEs compared to the less successful ones. This might be interpreted as an indication of the inability of SMEs in transition to act as the engine driving regional economic regeneration (Hardy and Rainnie 1996). If so, the question arises to what extent local-level policies for SMEs might redress this trend. In order to address these questions in greater depth, the following sections look by means of case studies at the development of SMEs and SME policies at the local level in Hungary and the Russian Federation.

## 7.2. Local economic development in Szabolcs-Szatmár-Bereg (SSB) county

### 7.2.1. Regional characteristics

Szabolcs-Szatmár-Bereg county (SSB) is the easternmost region of Hungary bordering the Ukraine, Slovakia and Romania. It covers an area of 5,937 sqare kilometres, making it one of the largest counties in Hungary. In terms of resident population it also features among the most populated counties in Hungary with 572 thousand inhabi-

tants. The ratio of urban population, however, is at 38.5% the second lowest in Hungary. The centre of the county is Nyíregyháza, the 7th largest town in Hungary with 115 thousand inhabitants.

Table 7.5: Szabolcs-Szatmár-Bereg county in figures (1997)

| | SSB | Hungary |
|---|---|---|
| **General indicators** | | |
| area (square km) | 5,937 | 93,030 |
| number of population | 571,824 | 10,091,789 |
| population density (persons/ square km) | 96 | 108 |
| **Gross Domestic Product** | | |
| GDP at purchasers' prices (million HUF) | 278,547 | 8,540,669 |
| GDP per capita (thousand HUF) | 487 | 841 |
| GDP per capita in order of counties | 19 | - |
| **Employment** | | |
| number of employees | 96,576 | 2,334,229 |
| net earnings (HUF/ month) | 31,661 | n/a |
| rate of unemployment | 11.8 | 8.3 |
| **Investment** | | |
| domestic investment (million HUF) | 67,468 | 2,137,879 |
| per capita domestic investment (HUF) | 117,987 | 211,843 |
| Foreign Direct Investment (billion HUF) | 14.8 | 2,039.8 |
| Local Government Budget | | |
| revenues (billion HUF) | 74 | 1,554 |
| expenditure (billion HUF) | 73 | 1,530 |
| balance (billion HUF) | 1 | 24 |

Source: KSH 1999, own calculations

SSB can be described as a rural and underdeveloped county. Although the quality of the soil is considered to be poor, SSB is Hungary's most important producer of apple crops. Furthermore, one-sixth of Hungary's tobacco as well as potato crops are grown in SSB. The agricultural sector is characterised by a large number of small-scale private farms as well as cooperative farms, although the cooperatives are showing signs of decline. According to A.Kémeri of the Cooperative Research Institute in Budapest[6], this can be viewed as a legacy of the socialist period, when cooperative forms of organisation were a means of avoiding full nationalisation. In the wake of liberalisation

[6] Interview with A.Kémeri, 22nd November 1993.

of the agricultural sector and associated ownership reforms, many farmers preferred private ownership over what they viewed as top-down imposed cooperative forms. However, in the light of the absence of a government agricultural policy, small-scale private farms are greatly disadvantaged.[7] Alongside the lack of investment into farming equipment and restricted access to European Union markets, the unfavourable size structure of farms accounts for a relative decline in agricultural production and increased shedding of labour from this sector (Galo 1996).

The county's industry is, not surprisingly, dominated by food-processing, mainly vegetable and meat-processing. Other industries include chemicals (represented by two large plants producing pesticides), pharmaceuticals (around the town of Tiszavasvári) and agricultural tyres. The remaining manufacturing enterprises are predominantly in light industry, especially textiles and shoe production, in furniture production, manufacturing of optical lenses, water meters and electrical bulbs (Hajnal 1996).

SSB, in 1993, had the highest unemployment rate in Hungary at 22.4 percent. Even though that figure had decreased to 11.8 percent in 1997, it remains one of the highest in Hungary. According to the Nyíregyháza Employment Office[8], these figures might in reality be even higher due to a large number of female workers not being officially registered as unemployed. It has been argued that this factor is exacerbated in SSB due to the rural character of the region, where the traditional role of women looking after home and family remains often untouched. There are several reasons that have been advanced in interviews for the above average unemployment rate in SSB:[9]

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[7] European Union accession and in particular participation in the Common Agricultural Policy would clearly bring great benefits to the farmers in the region.

[8] Interview with F.Török, 22nd September 1993.

[9] Interviews with F.Török, 22nd September 1993; T.Hagymási, 22nd September 1993; L.Kis, 20th September 1993 and M.Jászai, 21st September 1993.

- As in many other counties, previously state-owned enterprises are shedding large numbers of workers in the process of restructuring and/or privatisation. In addition many firms in SSB were subsidiaries of other state-owned firms and were often closed in the general process of restructuring (see also Kakukne 1996).

- The breakdown of cooperative farms caused large numbers of farm workers to exit the labour market. The employment potential of new small farms appears to be limited.

- A large number of the working population in SSB was employed prior to the transition in and around the urban conglomeration of Budapest. The economic restructuring of state enterprises there caused very large lay-offs of workers. Commuters especially were affected by this restructuring as enterprises spun-off or liquidated peripheral activities such as free housing for workers.

- SSB has an above average population of gypsies, who are frequently excluded from labour markets due to past and present discrimination.

- The level of skills is relatively low, limiting alternative employment possibilities.[10] This problem is aggravated by an increasing "brain-drain", whereby mostly young and skilled workers are seeking employment in the more affluent regions in Western Hungary or even Western Europe.

As already mentioned, SSB is economically one of the most underdeveloped regions in Hungary and the problems are particularly serious in the field of infrastructure. The road and railway systems are in urgent need of repair and expansion, especially in order to facilitate increasing crossborder traffic and trade. One of the most urgent areas of

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[10] However, the percentage of skilled unemployed continues to rise due to the other factors mentioned above. Approximately 30 percent of the unemployed in SSB are skilled labourers (Kakukne 1995).

development is telecommunication, particularly the extension and upgrading of the existing telephone network.[11]

SSB has (at least temporarily) been adversely affected by the collapse of trade with Eastern Europe due to the breakdown of the CMEA. It has been estimated that Hungary lost (overnight) approximately 25 percent of her markets and the figure for SSB is estimated at around 60 percent (Attwater 1993). This event contributed to economic downturn in SSB in the short run, but in the long run the geographical position of SSB has inherent advantages, not only for trade between SSB and the neighbouring countries, but also for the development of SSB as a spearhead for Western European firms seeking to develop their market share in Eastern Europe.[12] The rapidly increasing numbers of small firms in the haulage and transport sector along the border region is evidence of that potential (Szabo 1996).

Given the peripherality of the region and its largely rural character, SSB has not been a magnet for foreign investors, and only about 350 companies have foreign participation, although the share of foreign investment has shown a steady upward trend. Key investments include the Tobacco Fermenting Co. owned by the American Universal Leaf Tobacco, the Carl Zeiss Hungaria Ltd. owned by the German Zeiss company, and the Tungsram factory in Kisvarda owned by the American firm General Electric. Most of the foreign investment stems from large multinationals which, for example in the case of tobacco, are extending their global oligopolistic position into the frequently unsaturated markets of Central and Eastern Europe. There is as yet little evidence that

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[11] The number of telephone stations per 100 population was 7.7 in 1992 compared to the Hungarian average of 15.5 at the time. The installation of fibre optical cable has recently begun.

[12] Much depends here also on the potential for future European Union enlargement, with Slovakia and Romania awaiting in the second tier of new members. The currently burgeoning shuttle trade with the Ukraine might, however, suffer as a result of the hardening of borders in the event of Hungary joining the European Union.

foreign investment acts as an engine for the development of the local economy[13] and, except for the case of Nyidofer[14], the local supply links remain weak.

### 7.2.2. The small firm sector in SSB

Even in SSB, with its constraining features, the development of small firms in the county as a whole has been rapid, as in all parts of Hungary. Between 1990 and 1994 the number of enterprises in SSB tripled, a development that can be explained by the growth in the number of microenterprises (Szabo 1996). However, there are considerable spatial variations, with most of the new small firms clustered around the county centre of Nyíregyháza and the south-eastern border regions. The small firm sector in SSB exemplifies many of the weaknesses that have earlier been identified in respect of Hungarian small firms. As noted in table 7.1., only about 75 percent of registered enterprises are operational, suggesting the existence of a significant number of phantom companies. The vast majority of small firms are sole proprietorships accounting for 75 percent of active enterprises in the region in 1997. The average enterprise in the region employs less than 20 employees (Szabo 1996). Given that SSB falls below the Hungarian average for small firm density, it could be argued that the phenomenon of 'too few, too small' is evident. This trend is further highlighted when looking at sectoral distribution where trade and repair services dominate accounting for more than a third of small businesses (see table 7.6.).

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[13] Barath and Szalo (1990) document the case of externally-determined regional development on the example of Szekesfehervar which is today one of the key foreign investment locations in Hungary. They found that the presence of large Fordist organisations stifled the development of indigenous small firms and that the capacity to develop local policies was stymied by the considerable influence of policies from the centre. According to the study, the long-term benefits to the local community are in serious doubt.

[14] The company has, since the takeover by Universal Leaf Tobacco, invested heavily in increasing quality standards of local suppliers of tobacco.

Table 7.6: Sectoral distribution of enterprises in SSB, 1993 (in percent)

| | Legal entities | Non-legal entities | Budgetary organisations | Sole proprietors | Other | Total |
|---|---|---|---|---|---|---|
| Agriculture and fishery | 13.8 | 6.0 | 0.4 | 1.8 | 3.0 | 3.0 |
| Manufacturing | 19.7 | 14.0 | - | 11.7 | 0.1 | 11.6 |
| Construction | 9.3 | 7.7 | - | 9.0 | - | 8.2 |
| Trade and repair | 37.8 | 36.0 | - | 36.5 | 0.2 | 33.9 |
| Hotels and restaurant | 1.1 | 3.5 | 1.8 | 6.8 | 0.1 | 5.7 |
| Transport, storage and communication | 4.1 | 3.1 | 0.4 | 11.7 | 0.2 | 9.7 |
| Real estate | 10.5 | 24.0 | - | 15.3 | 1.7 | 14.6 |
| Public administration | - | 0.2 | 43.0 | - | 0.4 | 1.0 |
| Education | 0.5 | 1.8 | 37.2 | - | 1.6 | 1.1 |
| Health and Social Work | 0.4 | 1.2 | 10.4 | 1.4 | 1.9 | 1.5 |
| Other community and social | 1.6 | 2.0 | 6.7 | 5.7 | 90.4 | 9.5 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

Source: KSH Szabolcs-Szatmár-Bereg Igazgatosaga 1993

Approximately only 12 percent of small enterprises were engaged in manufacturing, a figure which is likely to be further distorted by the existence of phantom companies and the trend for multi-sectoral profiles. Furthermore, where small industrial businesses operate, such as in the textile and shoe industry, they frequently engage in cut, make and trim (CMT) for Western producers with the high value-added component accruing outside the local market (Hajnal 1996). Linkages between enterprises in the county are often based on quasi-market relations and networking is confined to a jealous guarding of segments of the market.[15]

Given the pronounced economic recession experienced in the region, a major factor in the emergence of small firms, in particular sole traders, has been push-factors related to the lack of wage-employment opportunities in the traditional sectors.[16] The decline of

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[15] One of the enterprises visited was a small bakery which competed in the market with two other private bakeries and a large state-owned bakery. Since it was felt that the state-owned bakery had an unfair competitive advantage due to public purchasing policies and various forms of government aid, the small private bakeries saw their only chance of survival in carving up the remaining market amongst themselves and refraining from cut-throat competition (interview with A.Kovács, 24th September 1993).
[16] Interviews with M.Jászai, 21st September 1993 and Dr.Hagymási,22nd September 1993.

large manufacturing companies in the region, combined with the exodus of labour from the agricultural sector, has spawned the growth of self-employment. This trend has been aided by a variety of labour market policies (Godfrey and Richards 1997) aiming to alleviate the increases in the unemployment rate and stem the brain-drain from the region. The local employment centre, for example, provides financial start-up support to new enterprises and subsidises new workplaces in existing firms.[17] The average assistance for new job creation was HUF 260,000 (or approximately £2,000 at 1993 prices). Yet, despite the massive growth of self-employment documented above, the number of job seekers showed a dramatic increase until 1993 and thereafter only a slight levelling out. According to surveys conducted by the County Labour Centre (Kakukne 1996), the reduction in the rate of unemployment was the result of small increases in labour demand by, on the one had, a number of established firms and of active labour market policies, including wage subsidies, on the other. There is no evidence that the growth of small firms has yet mitigated the unemployment problem in the region.

The development of small firms in the region is negatively influenced by a number of factors. Firstly, given the continuing depressed state of the regional economy, local demand remains low. Possibilities for exporting to the high value-added markets of western Europe are stymied by protectionist policies from the European Union and the lack of adequate infrastructural provision[18], combined with unfavourable geographic location and the lack of sophisticated information about foreign markets. Thus, in the foodprocessing sector for example, 80 percent of sales are realised in the domestic market[19], which is likely to remain depressed for the foreseeable future. A further impediment to the development of small firms in the region is the inadequate financial

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[17] Interview with F.Török, 22nd September 1993.

[18] The main problems here include the lack of motorway access connecting the region with the Western parts of Hungary and the poor state of telecommunications. During the field visit in 1993, M.Jászai of the Primom Foundation described how in one of the rural locations in the county, the local sub-office of Primom acted as the registered office for some twenty companies, as this was the only point with access to phone and fax lines.

[19] A notable exception here are alcoholic beverages with the region's Tokaj wines enjoying an international reputation.

services infrastructure. In 1995, 15 banks were operating in the county as well as 17 savings cooperatives. In proportional terms, SSB is underbanked in comparison to the rest of the country (Filep 1996). This problem is further heightened as many of the banks operate in the major cities of the county only, leaving an institutional vacuum in the majority rural areas which is only inadequately filled by smaller savings cooperatives. The provision of venture capital is absent apart from the North-East Hungarian Capital Investment Ltd. (Filep 1996). Another impediment to small firm development in the region is the lack of sophisticated information. A number of research institutes exist either in the region itself (such as the Agricultural College branch of the Gödöllö University) or are linked with the region's producers (for example Debrecen Agricultural University). Furthermore, a plethora of business support institutions have evolved that specialise in the provision of information. Yet these institutions benefit mainly businesses in urban conglomerations and the supply of information, as of financial resources, is uneven to the detriment of businesses in the rural regions.[20] A further barrier to small firm development is the lack of relevant skills of would-be entrepreneurs given the high percentage of gypsies[21] in the region, on the one hand, and the surplus of agricultural labour with what are increasingly viewed as redundant skills on the other.

Thus, in addition to the barriers to small business development highlighted in chapter 6, small firms in SSB face a number of additional impediments related to the local conditions of depressed demand and unfavourable spatial factors.

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[20] Interview with I.Kovács, 21st September 1993.

[21] In an interview carried out by Ilona Gere of the SEED Foundation, one of the interviewed gypsies described the situation as follows: "We live in a time of businesses but gypsies are destined to be shut out of this, too. For a business a tender is needed, which is quite disguised because gypsies do not possess conditions set out in the tender. Eg. financial conditions - no equity, no qualifications, no other conditions - they have no chance for starting a business at all." (Laszko and Soltész eds., 1997, p.52).

### 7.2.3. Local-level policies for SME support in SSB

In order to promote regional development in SSB, the Primom Foundation for Enterprise Promotion was set up in 1990, comprising a network of local actors in the enterprise sphere, including local banks, large firms such as Nyidofer and MOM[22], county and town council representatives, entrepreneurial interest representations such as VOSZ and local political parties. According to the Managing Director of Primom, the idea about a local economic development agency started to form in the minds of local officials in 1986, and between 1986 and 1990, he and several of his colleagues extensively researched ideas on local economic development and carried out a visit to Denmark to observe local initiatives there at first hand.[23] The outcome was the registration of a foundation under Hungarian law and the setting up of an office in Nyíregyháza in 1990 staffed by 6 people. The foundation was seeking to provide information services to local entrepreneurs and was modestly financed by the local government. However, the real activity of the foundation started in 1991[24] when Primom was chosen to be among the six pilot Local Enterprise Agencies set up by the Hungarian Foundation for Enterprise Promotion (MVA). With the inflow of financial means also came policy advice as regards the aims, objectives and policy instruments of the foundation through the involvement of the British company Lancashire Enterprise PLC. This British company was charged by MVA to develop a business plan for the region. The aim of Primom became:

> Creating and operating the ways and means of a programme aimed at developing the economy in Szabolcs-Szatmár-Bereg county, increasing and coordinating the

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[22] The name Primom includes the name of one of the large founding companies, the MOM Hungarian Optical Works. MOM contributed the vast majority of the initial start-up capital of the Foundation out of funds that it had originally received from the county's government in order to contribute to economic development in the region.

[23] Interview with I.Kovács, 21st September 1993.

[24] Although the foundation had the premises provided by the local government, effective work was stymied by political developments at the time and disagreement among the founding parties regarding the remit of the organisation (interviews with I.Kovács, 21st September 1993 and I.Kelemen, 21st September 1993).

domestic and foreign financial resources available for the purposes mentioned above. (Primom 1992)

Thus, Primom effectively took over local economic development in the county from local government which, although involved as founders in the board of Primom, has subsequently relinquished much of this function to the foundation. According to I.Kelemen, the local self-governments in the county were unable to financially support enterprise development at this stage and became, consequently, increasingly marginalised in the policy-making process.[25] I.Kovács, on the other hand, has argued that the close involvement of local government in the start-up phase of Primom considerably slowed-down the decision-making process as different political parties frequently disagreed over approaches to enterprise support.[26] The 'new' Primom became a *de facto* private sector institution.

Given the emphasis by MVA on small firm development as a vehicle for economic regeneration and the recognition that SSB is unlikely to be a great magnet for foreign investors, the promotion and expansion of the small firm sector in the region became the main goal of the foundation. However, the specific objectives of the foundation remain unclear - the support of small firm development has a popular appeal yet the way in which they contribute to local economic development and which firms are most likely to alleviate local economic constraints where neither defined nor operationalised through the deployment of appropriate instruments. Although a number of sectors such as tourism and agro-processing were highlighted as areas of competitive strength in the business plan of the county drawn up by Lancashire Enterprise PLC[27], there has been no evident sectoral focus in the delivery of policy.

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[25] Interview with I.Kelemen, 21st September 1993.
[26] Interview with I.Kovács, 28th September 1993.
[27] Interview with J.Attwater, 8th August 1993.

The instruments that the foundation utilised in order to achieve its goals reflect needs of firms identified by the centre (MVA) rather than specific local needs. Thus, Primom is responsible for the administration of MVA financial schemes such as the START credit or the microcredit programmes which are channelled through the local banks. In addition, Primom runs a training and education programme for entrepreneurs and provides business advice with the help of a business data bank. In 1991, a business incubator was set in the former Soviet barracks on the outskirts of Nyíregyháza in order to facilitate the development of start-up companies. In 1993, the incubator housed 25 businesses and 35 offices and workshops, employing a total of 200 people on the premises. The tenants pay in the first year 75 percent of the local market rates for rent and can utilise a range of services such as typing, photocopying, fax, meeting and guest rooms either free of charge or at a subsidised rate.[28] The rates for rent and services increase during the period of tenancy so that after 4-5 years the businesses are paying full market rates and are able to leave the incubator.[29]

A number of observations can be made in respect of the efficacy of these instruments. As far as the delivery of financial services is concerned, Primom, being on the one hand one of the pilot LEAs and, on the other, recognised as operating in a disadvantaged region, has benefited from a substantial share of central MVA funds. It received, for example, 11.5 percent of all disbursed microcredits in Hungary up to May 1996 (Vajda 1996). Nevertheless, demand far outpaced supply, with programmes such as the PHARE loans being oversubscribed by 104 percent (Environmental Resources Management and MVA 1993). Furthermore, although agriculture and foodprocessing are identified by policy-makers as priority sectors, the majority of financial funds were channelled to

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[28] Interview with I.Zsukk, 20th September 1993.

[29] During the the field visit, the premises of the incubator house were in the process of being expanded. At the time, none of the tenants had left the incubator and therefore no assessment can be made as to how effective the phasing out is.

service sector enterprises.[30] One of the members of the Primom board, when asked about the criteria for selection, stated that any enterprise can get a preferential loan "...as long as it guarantees it makes a profit." (interview with L.Kiss, 20th September 1993). Given monthly repayment schedules and credit period ceilings, this approach might well deter manufacturing firms that are often not able to generate quick returns on investments. Furthermore, since the key criteria for the success of programme is the limitation of default rates[31], it focuses necessarily on companies with a perceived low risk, or, in other words, companies that commercial banks might consider lending to. Exclusion is further fostered through the collateral requirement for some of the schemes which have been as high as 100 percent in the case of microcredits for example. Given the disbursal of financial instruments through the local banks, the problem of financial provision to rural enterprises (where there is no branch network) is not adequately addressed although attempts have been made to advertise the availability of the schemes through the network of county sub-offices.

A further weapon in the armoury of small firm policy instruments, the business incubator, is not unproblematic either. Having received premises from the local government and capital for refurbishment from PHARE MVA funds, the incubator started functioning in 1992 with the aim to eventually become self-sustainable although non-profit making.[32] The tenants in the incubator reflect this market-driven approach. Out of the initial 60 units in the incubator, 35 were offices for housing private business services companies, with the remaining 25 units a mixture of trade, repair and industrial firms. Having the potential to promote clustering of industrial enterprises, the incubator instead represents a cross-section of businesses, including a car repair shop, a textile

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[30] For example, 51 percent of the volume of microcredits were disbursed to service sector enterprises followed by 40 percent to agricultural with the remaining meagre 9 percent going to manufacturing firms (Environmental Resources Management and MVA 1993).

[31] Interview with I.Kovács, 28th September 1993.

[32] Interview with I.Zsukk, 20th September 1993.

company, a bakery and various business services such as accountants and secretarial offices, with limited potential for constructive inter-firm linkages and weak synergies.

As far as the provision of training and information is concerned, Primom has addressed some of the needs of local small firms in respect of business skills. However, the lack of linkages with scientific institutions somewhat limits the possibilities for the support of sophisticated information where market failures are usually most acute (see chapter 6). Furthermore, attempts to promote the sharing of information among small businesses through workshops and evening classes have not proved to be very successful as participants were reluctant to divulge information about themselves or their businesses.[33]

Overall the Primom Foundation has made a number of steps in the promotion of local small firms in order to strengthen the regional economy. However, the neo-liberal consensus that exemplifies the approach of the centre (i.e. the Hungarian Foundation for Enterprise Promotion) has deeply coloured local economic development policies and has thus not significantly addressed the fundamental weaknesses of the small firm sector in SSB. As in the case of MVA, foreign consultants were instrumental in shaping the nature of institutions and policies. Furthermore, the taking over of responsibility for local economic development from local governments, by an essentially private sector institution, raises the question as to whether it is best suited to deliver such policies. This is especially pertinent in the light of discontinued PHARE funding and the inability to achieve self-sustainability in the realm of small firm sector promotion only (Gibb and Haas 1996). Already we have seen, therefore, a strengthening of regional development institutions with the involvement of regional and local governments such as the Regional Development Fund (Szabo 1995, Primom 1995). However, at the time when the interviews were conducted, regional and local government representatives in

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[33] Interview with L.Róka, 21st September 1993.

particular expressed their scepticism as regards a potential role in small firm sector support in the light of inadequate local government financing mechanisms. Local government is constrained by its legal obligations for the provision of a minimum level of services, maximum levels of taxation and limited potential for borrowing of additional funds (OECD 1996, Bird et al. 1995). Hence, any more active role of local government as opposed to private sector institutions in local economic development necessitates not only a fundamental change in the prevailing economic consensus but also legal reforms to solve some of these fiscal problems. On the more positive side, there is a genuine attempt made by Primom to involve local stakeholders such as local governments, financial institutions and large enterprises in the decision-making process. This was particularly evident in 1990 when Primom relied on funding from these sources. The inclusion of Primom in the LEA network administered by Phare both strengthened and weakened the local networking effect. As already mentioned, local government increasingly felt marginalised as Primom turned into a private sector institution. On the other hand, networking with local banks was strengthened as those were the prime vehicle through which financial resources were disbursed.

Although Primom has sought to develop local solutions to SME development, the organisation has been constrained by the strong top-down approach practiced by Phare. The following section will look at the example of Budapest and small firm development and small firm policies in the context of a central and prosperous region.

## 7.3. Local economic development in Budapest

### 7.3.1. Regional characteristics

Budapest is economically the most advanced of the Hungarian regions. With a population of over 2 million it is the largest urban conurbation in the country.

Table 7.7: Budapest in figures (1997)

| | **Budapest** | **Hungary** |
|---|---|---|
| **General indicators** | | |
| area (square km) | 525 | 93,030 |
| number of population | 1,838,753 | 10,091,789 |
| population density (persons/ square km) | 3,502 | 108 |
| **Gross Domestic Product** | | |
| GDP at purchasers' prices (million HUF) | 2,950,304 | 8,540,669 |
| GDP per capita (thousand HUF) | 1,575 | 841 |
| GDP per capita in order of counties | 1 | - |
| **Employment** | | |
| number of employees | 649,890 | 2,334,229 |
| net earnings (HUF/ month) | 48,168 | n/a |
| rate of unemployment | 5.5 | 8.3 |
| **Investment** | | |
| domestic investment (million HUF) | 674,116 | 2,137,879 |
| per capita domestic investment (HUF) | 366,616 | 211,843 |
| Foreign Direct Investment (billion HUF) | 1,119.6 | 2,039.8 |
| Local Government Budget | | |
| revenues | 488 | 1,554 |
| expenditure | 487 | 1,530 |
| balance | 1 | 24 |

Source: KSH 1999, own calculations

The sectoral structure of the county comprises a mixture of industrial and services sector activities. The share of the latter has shown significant growth over recent years whilst in particular heavy industry has experienced a marked decline. A number of sectors of the Hungarian economy are almost exclusively located in the capital (see table 7.8.). Nearly one third of all Hungarian enterprises are located in Budapest and the county contributes approximately 60 percent of all Hungarian taxes (Budapest Enterprise Agency 1997).

Table 7.8: Share of Budapest companies in turnover of economic sectors in Hungary in 1996 (percent)

| | |
|---|---|
| Insurance | 100 |
| Petrol industry | 99 |
| Financial Services | 93 |
| Telecommunications | 92 |
| Transport | 89 |
| Computer technology | 80 |

Source: Budapest Enterprise Agency 1997

Budapest has also been a major destination for foreign investment into Hungary (see table 7.7.). In some sectors such as postal services and telecommunications, financial services and retail trade, it has received the bulk of foreign investment coming into the country. Unemployment in the county is low, at 5.5 percent Budapest falls below the national average.

A number of factors are responsible for the favourable economic development of the county. Historically, Budapest has been one of the commercial centres of the Austro-Hungarian empire. Even during the socialist period, trade and commerce remained one of the mainstays of the local economy and subsequent structural reforms have had a less devastating impact than in regions with mono-sectoral profiles. Secondly, Budapest has a well-endowed physical infrastructure, being at the hub of the country's road, rail and air network. Privatisation of municipal infrastructure with frequent participation of foreign investors has led to further improvement and upgrading. Budapest is also favourably endowed in respect of soft infrastructure, accounting for half of Hungarian university students and hosting 78 percent of business service enterprises in Hungary Budapest Chamber of Commerce and Industry 1996). A further advantageous factor is the presence of foreign investors in Budapest, which create many opportunities for local companies. Lastly, since Budapest is the capital of the country and the seat of the

government, there is also a more or less tangible 'capital bonus' exerting a pull on business activities.

There are, however, less positive features. Economic development within the county is uneven, with the Buda parts increasingly developing into suburban retreats for business executives whilst in the more industrial Pest side the development of slums can increasingly be observed. The city also suffers considerable environmental problems with much of its sewage finding its way untreated into the Danube. The maintenance of the physical infrastructure placed a burden on precarious local government finances. Following devolutionary legislative reforms between 1990-1991, the Budapest municipality attained greater control over fiscal matters, however, central sources accounted for 66% of revenues in 1993 (Ebel and Simon 1995) indicating a high level of dependence on policies conducted by the centre. As the central government has been seeking to control its budget deficit and has therefore cut back on transfers to local authorities, the ability of the Budapest municipality to spend on public services has also diminished (Fabian et al. 1995). According to Ebel and Simon (1995), there is an urgent need for Budapest to identify and implement own-source revenue options including a property tax system. Thus, although Budapest is one of the wealthiest municipalities in the country, its financial resources are constrained due to the nature of the prevailing fiscal regime. The following section considers the development of small firms in Budapest.

### 7.3.2. The small firm sector in Budapest

Budapest is leading the trend as regards small firm sector development in Hungary. As table 7.1. has highlighted, the city has the highest density of operating small firms in the country and has almost reached the level of SME density of market-type economies. It is also more balanced than other regions in terms of the distribution between sole traders

and corporations which is almost even. However, sectoral distribution in Budapest is not radically dissimilar to SSB, as table 7.9. highlights.

Table 7.9: Sectoral distribution of Budapest-registered private enterprises in 1996 (in percent)

| | **Sole Proprietors** | **Total Private Enterprises** |
|---|---|---|
| Agriculture and fishery | 0.9 | 0.8 |
| Mining and Quarrying | 0.0 | 0.0 |
| Manufacturing | 10.7 | 11.6 |
| Utilities | - | 0.0 |
| Construction | 6.8 | 6.8 |
| Trade and repairs | 27.6 | 28.3 |
| Hotels and restaurants | 3.2 | 3.0 |
| Transport, storage and communications | 9.7 | 6.2 |
| Financial intermediation | - | 0.5 |
| Real estate, renting and business activities | 31.5 | 28.2 |
| Public administration and defence | - | 0.1 |
| Education | - | 1.2 |
| Health and social work | 1.2 | 1.7 |
| Other community and social services | 8.4 | 11.5 |
| Total | 100.0 | 100.0 |

Source: Budapest Chamber of Commerce and Industry 1996

Again, trade and repair account for the business activities of almost a third of Budapest's small firms. Another sector that is heavily represented is real estate and business services which can also include knowledge-based companies. In the absence of further disaggregated data, there is only recourse to anecdotal evidence pointing to the gradual emergence of knowledge-based businesses, a key source of competitive strength in the information-driven global environment.[34] The number of manufacturing small businesses is again not very substantial and is inflated not only through the existence of phantom companies but also via the fact that many businesses registered in Budapest operate outside the capital in order to avoid the higher than average labour costs and overheads.[35] However, the operational manufacturing enterprises are starting to develop

[34] Interview with A.Rezner, 29th July 1997.
[35] Interviews with Z.Györfi, 24th July 1997 and I.Susuk, 24th July 1997.

linkages with larger firms, especially foreign investors, and local clusters of industrial firms have evolved, for example, in metal working, electrotechnics and electronics and plastics and rubber (Budapest Enterprise Agency 1997). Local institutions such as the Budapest Enterprise Agency are aiding this trend through programmes aimed at increasing the level of subcontracting to local firms by foreign investors. However, there is as yet little evidence of the kind of inter-firm cooperative links witnessed in the Emilian model.[36] This issue will be returned to in chapter 8.

Whilst small firm development in SSB has largely been push-driven, the development of small firms in Budapest has be viewed in the context of both push and pull factors. On the one hand, structural reforms in traditional sectors have greatly swelled the ranks of the unemployed in Budapest, even though the unemployment rate is substantially lower than in the rest of country. Futo (1995), for example, documents cases where small firms emerged as a result of large firms downscaling, spinning-off entire departments or where technical specialists started their own businesses due to the decline in state-financed R&D institutions. Nagy and Soltész (1996) describe the birth of the GAMMAX Ltd. software and hardware company in Budapest as a result of senior managers losing their jobs in a joint venture company. A.Rezner, from the Budapest Chamber of Commerce, argued in an interview that a large proportion of the microenterprises that are members of the chamber are 'forced' entrepreneurs[37], the exact numbers are however unknown.

On the other hand, some surveys suggest the entry into the small business sector is not predominantly motivated by unemployment-push (Bartlett and Hoggett 1994). The relatively favourable economic conditions in Budapest combined with the demand

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[36] Kuczi (1993), in a study of enterprises in a village immediately outside Budapest, "...found a type of organisation corresponding in many respects to what is known as the industrial district phenomenon in the literature...." (Kuczi, 1993, p.1). Aside from this single study, however, neither the field work in the country nor secondary literature offered further examples of the type of competitive and co-operative linkages that exemplify the industrial district model.

[37] Interview with A.Rezner, 29th July 1997.

generated by foreign investors have increased the attractions of self-employment and acted as a strong pull factor. One such example described by Nagy and Soltész (1995) is that of Vizuál Ltd., a producer of flipcharts in Budapest. The idea for the venture was born when the owner and director was approached in his previous job by an English consultant asking for flipcharts. The subsequent market research showed that there was no supplier of flipcharts in Hungary and large Hungarian and foreign companies emerged as customers. Thus, the evidence suggests that the dynamics of small firm development in Budapest appear to be less explainable in the framework of a monocausal-explanation approach. Rather, a variety of factors are at work bringing about the birth of new companies in the city.

Whilst, in general, conditions for the development of small-scale enterprise appear to be more favourable in Budapest owing to buoyant local demand conditions and a relatively sophisticated business infrastructure, there are a number of barriers to small business development distinct to Budapest. Given the high level of urbanisation, space is at a premium and hence business costs are higher compared to more peripheral locations.[38] Furthermore, a number of sectors are reaching saturation levels and competition is increasingly fierce and price-based (interviews with G.Bényei 30th July 1997, K.Kóka 22nd July 1997, see also Sik 1994, Nagy and Soltész 1996). Thus, the scope for retained earnings and reinvestment might be limited. Despite the plethora of business advice and information institutions, information is often difficult to come by hindering both births and growth of small firms.[39] Risk capital although more easily available than in the peripheral regions, is also scarce (Karsai 1998). The combination of high growth in the numbers of small businesses and prevailing barriers to growth has led in Budapest to the phenomenon of 'too many, too small' (Gabor 1997), with enterprises following the 'low road to competitiveness' as evidenced by low investment, low wages and the formation

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[38] Interviews with Z.Györfi, 24th July 1997, P.Süle, 24th July, A.Sztanko 28th July 1997, G.Bényei, 30th July 1997.

[39] Interview with A.Rezner 29th July 1997.

of cartel-like organisations to maintain a minimum level of income (Sik 1994). The following sections will look at if and how local policy-makers have sought to address this situation.

### 7.3.3. Local economic policies in Budapest

The main organisation in Budapest responsible for the development and implementation of local economic policies in general and small firm support in particular is the Budapest Enterprise Agency (BEA). Prior to the setting up of the BEA, the Budapest municipality and the 23 local governments within the territory of the city supported enterprise development, albeit on a small scale due to the above outlined financial constraints. The assistance rendered mainly included support with premises and information services subsidised by the municipality. In total, the Budapest municipality spent 0.4 percent and 0.2 percent of all expenditure in 1991 and 1992 respectively on support to entrepreneurs (Ebel and Simon 1995). The relatively low expenditure on small firm support has to be viewed in the light of the budgetary constraints that Budapest faced and the need to spend in particular on social services in repressed districts such as Rozsavaros (Fabian et al. 1995). With the setting up of the BEA in 1993, much of the responsibility for small firm policies passed from the hands of the municipality to the quasi-private foundation. The Budapest municipality provided the building to house the BEA and is a member of the board of MVA, however, the municipality does not provide any direct financial support to the BEA.

The BEA was the last Local Enterprise Agency set up in the framework of MVA's network of agencies and as such shares many similarities with the Primom Foundation in respect of its market-driven approach, limited local government involvement and shortcomings as regards aims and objectives of small firm support. Like Primom, the BEA was set up with the help of foreign consultants (the London Enterprise Agency and the Wiener Wirtschaftsförderungsfond) that were also instrumental in drawing up the

business plan for the agency. There are, however, differences in the quality and quantity of instruments employed. In respect of financial services, Budapest entrepreneurs can tap into the same funding schemes as elsewhere but the overall allocation of credits to Budapest is lower. For example, Budapest received 3.9 percent of the total volume of microcredits disbursed in Hungary up to 1996 (Vajda 1996). One of the reasons for this low share is the late entry (and therefore eligibility) of the BEA into the MVA network. Leaving Budapest to the last was, however, a deliberate policy choice by MVA, since it was felt that the need for this type of institutional system for small firm support was less urgent in Budapest given the favourable institutional framework in terms of financial and real services institutions already in place.[40] This reasoning also applied in the allocation of financial means to the LEAs where it is perceived that the underdeveloped regions such as SSB have greater claim on the limited funds.[41] According to estimates of the BEA, some 400 enterprise in Budapest received financial assistance between 1995 and 1996[42], mainly in the form of microcredits. Even though demand outstrips supply for preferential loans, the problem is, in the view of policy-makers[43], less acute in the capital compared to the peripheral regions as Budapest boasts a critical mass of both domestic and foreign financial institutions that are increasingly providing finance for small enterprises. In the view of Budapest entrepreneurs, the types of financial assistance offered are inappropriate to their needs as especially microcredits involve "...too much work and too little money." (interview with K.Kóka, 22nd July 1997). This view is increasingly shared by managers at the BEA that have supported strategy changes at MVA away from start-up support towards existing firms (see chapter 6). As one manager put it in the interview "One million forint used to be enough, but not any more. We need to become more market-oriented." (P.Süle, 24th July 1997).

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[40] Interviews with J.Burns, 16th September 1993 and I.Maróczi, 23rd November 1993.
[41] Interview with L.Kiss, 20th September 1993.
[42] Interviews with Z.Györfi 24th July 1997, I.Susuk 24th July 1997 and P.Süle 24th July 1997.
[43] Interview with G.Borbély, 25th July 1997.

Another difference emerges in respect of international orientation. The BEA has actively promoted links with businesses especially in the Former Eastern bloc countries and representative offices have been set up in Moscow and Almaty. However, contrary to other services offered through the LEA network, there is little evidence that these developments are demand-driven since the share of trade of small firms with the former Eastern bloc is negligibly low. For example, in surveying foreign trade of Hungarian SMEs (Bonifert et al. 1998), the researchers found that only 4.8 percent of firms in the sample[44] were exporting to the Former Soviet Union countries (Russia and Ukraine only) with an even smaller proportion importing from that region. In total, however, the Former Soviet Republics accounted for 9.4 percent of Hungarian exports and 15 percent of imports in 1996. Thus, this particular service can be viewed as evidence of a trend that the LEAs, in the light of diminishing PHARE funding, are increasingly keen to pursue - the extension of services to clients able to pay market rates or, in other words, larger firms.

Lastly, there is recognition within the BEA that one of the key strategies for the promotion of a competitive and sustainable small firm sector lies in the promotion of inter-firm linkages and especially subcontracting arrangements with foreign investors where technology transfer can be maximised. Thus, the Agency has participated in the compilation of databases on subcontractors in order to identify clusters of competitive branches (Budapest Enterprise Agency 1997). Moreover, together with the Budapest Chamber of Commerce it is developing programmes to enable small firms to gain registration to internationally-recognised standards such as the European Union's ISO9001 quality standard. However, these efforts are impeded by the lack of a critical mass of small-scale manufacturing firms - for example, the subcontracting survey has identified 31 companies in the electronics and electrotechnical sector, and only two of those produce solar cells (Budapest Enterprise Agency 1997). Instruments to promote

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[44] The sample included only firms engaged in foreign trade and is therefore already biased towards foreign trade-oriented small businesses.

local clusters of small firms should precede attempts to instigate linkages. As Schmitz and Furlong (1995) have argued in the case of Kazakh small firms "... the above approach of fostering clusters or networks seems successful only where a critical mass of small enterprises already exists." (Schmitz and Furlong, 1995, p.23).

Budapest and its agency face similar prospects for the future in respect of diminished Phare support as outlined for SSB and Primom. BEA seems to be anticipating these developments in a more pro-active manner, developing services that can easily be transferred to larger clients. During the field work in summer 1997, the agency was, for example, developing a distance-learning training package for subcontractors which was expected to raise money from large firms engaged in subcontracting.[45] A potential problem with this increasingly market-oriented approach is that subsidised services to new or high-risk firms will fall by the wayside. Moreover, the return of some of these local economic development functions to local government control and management is probably more problematic in Budapest than in SSB given the highly-fragmented nature of local authorities in this spatially confined area. Thus, there is a real danger that small firm development becomes marginalised in any future local economic strategies that Budapest pursues.

The preceding two case studies have shown that the dynamics of local economic development in general, and small firm development in particular, show important variations in the two regions. SSB is a rural and underdeveloped region that has suffered in the wake of structural reforms and because of its peripherality. Budapest is weathering the transitional upheavals more successfully and the economy is showing signs of indigenously, determined albeit externally-influenced, growth. However, the differences are more important than they appear at first sight. In both economies the small firm sector is emerging in response to the decline of large firms and whilst it is

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[45] Interview with Z.Györfi, 24th July 1997.

able to mitigate some of the detrimental effects of large firm sector shrinkage, it is as yet showing little sign of instigating economic growth. The lack of domestically or internationally competitive industrial small firms typifies both regions. The policies developed to promote small firms have but a scant regard for sectoral focus and instead emphasise the need for 'success stories' thus inevitably concentrating their support on 'safe bets'. Moreover, there is an increasing trend towards providing services to larger clients as PHARE funding continues to decline and external pressures are put on the local agencies to become self-sustainable.

The weaknesses of the policies outlined above require a radically new approach to small firm sector support and Porter's (1998) 'diamond' theory opens valuable insights. He argues that

> Underlying the operation of the national 'diamond', and the phenomenon of clustering, is the exchange and flow of information about needs, techniques, and technology among buyers, suppliers and related industries. When such interchange occurs *at the same time that active rivalry is maintained in each separate industry*, the conditions for competitive advantage are most fertile. (Porter, 1998, p.152, italics added)

This, however, presupposes the existence of a critical mass of local firms or near equilibrium conditions which are not as yet evident in the two case studies observed due to the lack of entry and growth of new small firms. It is in this area that local governments in the 'Third Italy' have successfully intervened, and there are important lessons for the Hungarian regions. The potential for cluster formation exists in both regions - SSB for example has shown strengths in wine production, fruit conservation and fruit juice concentrates. Budapest is showing strengths in a number of branches including electronics and financial intermediation. Yet, important components of the diamond are lacking and local small firm support institutions can and should influence

these gaps. The following sections consider the development of small firms and small firm policies in the two Russian case studies.

## 7.4. Local economic development in the Tyumen *oblast'*

### 7.4.1. Economic profile of Tyumen *oblast'*[46]

The Tyumen *oblast'*, situated in Western Siberia near the industrial centres of Omsk, Yekaterinburg and Chelyabinsk, is currently among the wealthiest regions of the Russian Federation due to the huge oil and gas deposits found on its territory.[47] The Tyumen *oblast'* accounts for 68 percent and 91 percent of the Russsian Federation's oil and gas production respectively and was in 1995 responsible for 25 percent of the export revenues of the Federation (*Economica Weekly*, May 18-24, 1996). Perhaps not surprisingly, the fuel industry accounts for 80 percent of the regional volume of production in the Tyumen *oblast'* with the remaining industries closely related in fields such as chemicals, pharmaceuticals and engineering. Timber production is also significant (*Tyumenskie izvestiya*, 7th May 1995). Per capita incomes, adjusted for purchasing power parities, are above the Russian average and less than 15 percent of the population live below minimum subsistence levels (Bylov and Lavrov 1996).

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[46] See appendix 3 for an administrative map of the Russian regions.

[47] Two autonomous districts - the Khanty-Mansi and Yamalo-Nenets districts - are found on the territory of the Tyumen *oblast'*. The majority of the oil and gas reserves are actually located in these districts and they are also responsible for the majority of industrial output of the region. The resultant differences in economic development have been over the recent years a breeding ground for local separatism and the Tyumen authorities are keen to maintain strong relations with the two districts via for instance joint infrastructure projects.

Table 7.10: Tyumen *oblast'* in figures (1995)

| | |
|---|---|
| Area: | 1,435,200 square km |
| Population: | 3,156,800 |
| Population density: | 2 per square km |

| | Tyumen | Russian mean |
|---|---|---|
| **Economic competitiveness** | | |
| GDP (billion roubles) | 108,885 | 127,531 |
| per capita GDP (million roubles) | 34 | 10 |
| industrial productivity (million roubles/ employee) | 284 | 66 |
| **Labour market** | | |
| employed (% of labour force) | 94 | n/a |
| wage levels (1,000 roubles/ month) | 1,161 | 472 |
| **Investment** | | |
| expenditure for new construction and equipment (% of Russian total) | 12.8 | n/a |
| Foreign Direct Investment (% of Russian total) | 1.4 | n/a |
| **Government finance** | | |
| regional budget deficit (billion roubles) | -0.89 | n/a |
| arrears to the federal budget (billion roubles) | 292 | n/a |
| **Social indicators** | | |
| female life expectancy (years) | 71 | 72 |
| male life expectancy (years) | 58 | 58 |
| hospital beds (number per 10,000 population) | 112 | 126 |
| students in higher education (number per 10,000 population) | 125 | 179 |

Source: Centre for the Study of Public Policy 1999, NUPI 1999, Russian European Centre for Economic Policy 1997, own calculations

The Tyumen *oblast'* is, however, suffering from similar problems that have affected other Russian regions in the wake of transitional reforms. Production output fell by 7 percent in 1991, 15 percent in 1992, 13 percent in 1993, 12 percent in 1994 and 3.7 percent in first three quarters of 1995 (*Tyumenskie izvestiya*, 5th November 1995). This is, of course, somewhat lower than the Russian average for these periods and shows a slow-down in decline (see also Bylov and Lavrov 1996). Yet the resumption of growth is critically dependent on investment in the ageing capital equipment of the oil and gas sector which does not appear to be forthcoming (see table 7.10.). Fixed capital investment in the fuel and energy sector has almost halved between 1990 and 1996

(OECD 1997), with a large share (9 percent in 1996) concentrated in the Gazprom monopoly. This decline is largely a reflection of the sharp contraction in investments financed from the federal budget. Moreover, foreign direct investment, after initial growth, has been slowing down (Western Siberia attracted in 1994 116.2 million US$ or 21.2 percent of total FDI and only 78.2 million US$ or 3.7 percent of the Russian total in 1996) because of the unstable macroeconomic environment and the uncertain legal situation, especially in respect of foreign ownership of oil and gas enterprises (Watson 1996). It is unlikely that the investment situation will improve soon given the mass exodus of investors from the Russian market in the fallout from the 1998 crisis.

Unemployment in the region has been increasing only slowly, reaching 2.9 percent towards the end of 1995 with the highest level (3.6 percent) in the resource-poor south of the region (Tyumenskii gorodskoi tsentr zanyatosti as quoted in *Tyumenskie izvestiya*, 5th November 1995). The problem is, however, masked by data collection problems on the one hand (see different estimates in table 7.10) and the persistence of 'hidden' unemployment on the other (*Tyumenskie izvestiya*, 5th November 1995, see also Morvant 1995, Morvant and Rutland 1996). And although Tyumen is classed as a 'rich' region with high growth in nominal per capita income between 1990 and 1995, income inequality is high (Bylov and Lavrov 1996).

Despite its somewhat more favourable starting point in comparison to other regions, the Tyumen *oblast'* has not distinguished itself as a fast reformer. Indeed, Hanson (1994) points to the anti-reform attitude of leaders in resource-rich regions and quotes an interview with Yavlinsky, in which

> ... when asked why he did not start in Tyumen *(as a pilot region for bottom-up reforms)*, with its strong hard-currency base, he points to the complacency of local elites there; in contrast Nizhnii Novgorod, with its heavy defence-industry dependence, had leaders who saw no way ahead except through radical reforms. (Hanson, 1994, p.20, italics added)

Yet the need for structural reforms and more diversified economic structures is clearly desirable. Firstly, reliance on the oil and gas sector for the continued income growth is problematic due to exposure to fluctuations in world commodity prices. Secondly, a competitive oil and gas sector is critically dependent on a components supply industry which is thus far lacking in the region. From the point of local economic development, an indigenous supply sector would be advantageous (Bateman 1997). Lastly, the lack of services, a legacy of the command economy, is marked in the region and needs to be addressed in order to achieve more balanced economic development of the region (Bradshaw et al. 1998). In order to achieve those aims, small firms have a critical role to play.

### 7.4.2. Small firm sector development in the Tyumen *oblast'*

The number of small firms in the Tyumen *oblast'* has shown a continuous increase even during the period of slowdown in growth of the Russian small firm sector. Between 1993 and 1996, the number of small firms increased from 8,399 to 33,581, raising the Tyumen share of total Russian SMEs from 1.7 to 3.8 percent (Goskomstat 1994 and OECD 1998). Employment in Tyumen SMEs, however, only doubled during that period, indicating that the job creation of the new SMEs is lower compared to the previously established ones with the majority of small enterprises employing less than 20 employees (Administratsiya Tyumenskoi Oblasti 1995). In terms of sectoral distribution, construction small firms accounted for 42.6 percent of SME output in 1995, trade and services for 39.7 percent, industrial firms for 17.6 percent and agricultural for 0.1 percent. These figures suggest that *industrial* SMEs in the region are relatively scarce.

Table 7.11: Density of SMEs per 1,000 population in selected regions (1993)

| Region | Total SMEs | Industry | Construction | Trade and restaurant | Other commercial | Science | Other |
|---|---|---|---|---|---|---|---|
| Moscow City | 12.42 | 1.77 | 1.54 | 2.28 | 2.88 | 1.69 | 2.26 |
| St.Peters-burg | 4.92 | 1.12 | 1.02 | 1.11 | 0.14 | 0.68 | 0.84 |
| Tula oblast | 2.52 | 0.47 | 0.51 | 0.93 | 0.11 | 0.16 | 0.34 |
| Novosi-birsk oblast | 3.94 | 0.6 | 0.91 | 1.4 | 0.14 | 0.35 | 0.55 |
| Tyumen oblast | 2.68 | 0.35 | 0.74 | 0.78 | 0.1 | 0.05 | 0.65 |
| Russia total | 3.23 | 0.62 | 0.62 | 0.99 | 0.27 | 0.23 | 0.5 |

Source: adapted from Kenter and Kroker, 1995, pp.109-114

Surveys of entrepreneurs (Administratsiya Tyumenskoi Oblasti 1995) in the Tyumen *oblast'* have shown that Tyumen entrepreneurs suffer from similar constraints to entrepreneurs in other regions, imposed by factors such as the uncertain economic and inadequate legal environment. There are, however, some significant differences. In terms of finance, Tyumen entrepreneurs ranked difficulty of access to working capital as a more serious obstacle to development than difficulty of access to investment finance. This is firstly a reflection of the lack of industrial SMEs, which are most in need of investment finance, in the region. Secondly, the existing 'investment-profile' SMEs have tended to be established for some time and/or are linked to large firms, both of which has reduced their demand for investment finance. For example, a saw mill visited in Tyumen had been established in 1987 following the laws on co-operatives. The majority of capital equipment had been bought with rouble credits between 1988 and 1991 and were paid off by 1993 as the high inflation reduced the costs of repayment.[48] A further obstacle highlighted in the survey is the high fiscal burden that reduces real profits and limits the scope for reinvestment. According to Vilkov (1996) the fiscal burden keeps increasing as enterprises and individuals do not pay taxes and "Nobody knows where

[48] Interview with P.Krasnov, 7th February 1996.

one third of the income of the poulation goes. In 1994, about 6 trillion roubles of cash went nobody knows where." (Vilkov, 1996, p.8, own translation). Lastly, the non-payment crisis (see Gaddy and Ickes 1998 for a detailed analysis) severely affects entrepreneurs, as their working capital is *de facto* reduced and there is widespread resortment to barter trade.[49] Problems surrounding registration and compliance costs are ranked less seriously (only 40 percent of entrepreneurs surveyed considered it a problem at all) with registrations costing around $300[50] and usually being processed in a week.

The relative deficiency of SMEs at the regional level, its weak sectoral structure and the barriers to growth and development identified above indicate a strong need for policy measures to support and strengthen the small firm sector in the region.

### 7.4.3. Government support for small firm sector development in Tyumen *oblast'*

The regional administration of Tyumen *oblast'* has been slow in developing both institutions for SME support and a coherent policy approach. Whilst in 1993 both a Fund and a Committee for SME support existed following the model developed at the federal level[51], the latter was dissolved two years later with its functions being transferred to the Fund (*Tyumenskii Oblastnoi Fond Gosudarstvennoi Podderzhki Predprinimatel'stva i Razvitiya Konkurentsii* henceforth Fund) and the Committee for Economy and Forecasting (*Komitet po Ekonomike i Prognozirovaniyu*) at the regional administration.[52] In addition, the Committee for Labour, Employment and Migration (*Komitet po Trudu, Zanyatosti i Migratsii*) has a fund (about 18 billion roubles between 1993-95 according to estimates from the Centre for Labour Market Studies in Moscow),

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[49] Interview with V.Salmin, 2nd February 1996.

[50] In 1995 at current prices. However, in other regions the registration costs have since increased drastically (see OECD 1998) possibly affecting Tyumen as well.

[51] See chapter 6 for structure.

[52] Interview with M. Matyushenko, 1st February 1996.

some of which was spent on start-up subsidies (approximately 0.6 percent) (OECD 1998).

Although two programmes for the support of SMEs in the Tyumen oblast (1994-95 and 1996-97) have been drawn up, little action has been taken. The main obstacle in the view of the Fund and of other observers (Vilkov 1996) has been the lack of resources made available to the fund. The 1994-95 programme envisaged the availability of Rb13.845 billion both from federal and regional sources but although it was approved by the regional governor (Roketsky), only Rb1.5 billion were actually available[53], most of which came from regional sources. The Federal Foundation for SME Support that co-ordinates the disbursal of federal funds to the regional level had by the end of 1996 not received any funding at all (OECD 1998). The shortfall of funds from regional sources is not a reflection of a budgetary crisis[54] but more of an unwillingness on behalf of the regional administration to invest in such programmes. As pointed out earlier, there have been few incentives for structural reforms at the regional level as the economy benefited from the revenues generated by the oil and gas sectors.

However, even taking into account the limited funds available for SME support, questions have to be raised also regarding the disbursal of funds. Although a number of infrastructural projects were envisaged in the original programme, including so-called 'zones of intensive entrepreneurship', information and advice centres and a technology park, only the latter had materialised in 1996.[55] The remaining monies went towards administrative costs and the financial support of selected[56] small firms. The latter takes

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[53] In the neighbouring oblast of Omsk, Rb14 billion were available for the same period (Vilkov 1996).

[54] The budget deficit for the Tyumen oblast including the two autonomous districts was 2.6 percent of GDP in the first three quarters of 1995 (Tyumenskie izvestiya, op.cit. and own calculations). This is considerably lower than most Russian regions although there are a small number that show surpluses (see Hanson 1994).

[55] The technopark was financed largely from a Rb1 billion grant from the Federal Fund for Innovation and a smaller contribution of Rb430 million from the regional budget. in 1996, 15 firms were located in the technopark, 10 of which could be described as being innovative (interview Mr. Shabarov, 6th February 1996).

[56] See also Alimova et al. (1995) for evidence of selective approaches in other regions.

the form of loan guarantees, and potential candidates are invited to submit bids which are then vetted by the Fund. At the beginning of 1996, one such bidding round had taken place and out of 6 selected projects, 2 had received financial resources channelled through local banks. Although exact figures are not known (or are not for disclosure), it was estimated that some Rb800 - 1,000 million were spent on loan guarantees for these two projects.[57] One of the firms was a small, employee-owned cafe and the support from the fund was aiming to turn it into a minifactory producing mineral water. The second enterprise thus supported was also an established venture and engaged in the production of bricettes and insulation materials. The loan was to be used for the acquisition of new technology for the production of heating materials from Russian suppliers, some of which were located in the oblast'.[58]

Given the scarcity of resources on the one hand and the demand for finance by Tyumen small businesses on the other (Administratsiya Tyumenskoi Oblasti 1995), these seem to be excessively large amounts. Entrepreneurs themselves feel that the non-transparent selection process is opening the doors to corrupt practices. Mr. Salmin, the owner of a local engineering company, for example argued that he is equally afraid of the state bureacracy and the mafia.[59] Many consider it to be a remnant of central planning, where the government decides when, where, what and how much is to be produced. Furthermore, by only supporting such a limited number of entrants, little is done to increase the total stock of small firms, thus failing to close the gap with other regions in terms of SME density.

A second problem with the local policies is in respect of the objectives of small firm policies. Both programmes (1994-95 and 1996-97) focus on the identification of problems of SMEs and develop a number of measures to address these problems. The

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[57] Interviews with M.Matyushenko, 1st February 1996 and V.Vasyuk, 1st February 1996.
[58] Interview with M.Matyushenko, 1st February 1996.
[59] Interview with V.Salmin, 2nd February 1996.

programmes also stress the need for a more balanced economic structure in the region, with SMEs as a key vehicle for diversification. The programmes, following federal guidelines, identify sectors in which SMEs should be promoted, namely:

- agricultural production and food-processing
- production of industrial and consumer goods (including pharmaceuticals)
- production, communal and commercial services
- construction
- innovative SMEs

(Administratsyia Tyumenskoi Oblasti 1994 and 1996)

Although sectors are highlighted, their very breadth effectively precludes any kind of sectoral focus, and competitive strengths of the local economy are not identified. Aside from that, the programmes do not outline any objectives for small firm policies other than pointing towards the federal programmes and the objectives outlined within. As has already demonstrated in chapter 6, these aims are unrealistic, and the selective approach, duplicated here at the regional level, inappropriate given the continued deficit in SMEs and the potential for destructive rent-seeking.

Aside from the governmental support structures, a number of non-governmental organisations are active in Tyumen in the field of SME support. At the time of the field research (beginning of 1996), no international support agency had established small enterprise support institutions in the Tyumen *oblast'*, although both the EBRD and TACIS were planning projects in the future.[60] There were, however, a number of non-profit making institutions at the regional level involved in entrepreneurship support such as the Tyumen Chamber of Commerce and various associations formed on the basis of sectoral affiliation. These institutions focus largely on the provision of soft services such

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[60] In 1996, the EBRD had started a training programme for local bankers with the aim of disbursing credit lines through local banks.

as partner search, translation and advice on foreign markets. Their role is seriously limited by financial factors. The Chamber of Commerce, for example, provides all its services free of charge to its membership, yet the limited numbers of members and hence fee income has severely curtailed the number of services on offer[61], in addition to which the services provided are less than high quality. For example, information provided by the chamber on external marketing is confined to information on prices in foreign markets. A further weakness is the relative lack of business infrastructure, including these non-profit service providers, at the local level (Vilkov 1996). Co-ordination between local-level support institutions is weak. Thus, the Fund, the Technopark, the Committee for Labour, Employment and Migration have each developed their own programmes and initiatives without seeking to co-ordinate those. A Small Business Development Fund of the Tyumen Region headed by A.Gorshkaliov has been seeking to establish itself in competition to the Tyumen Regional Support Fund, essentially duplicating it. However, due to the inability to raise resources from the local authorities for its activities, it has thus far remained dormant.[62] Small firm policy in the Tyumen *oblast'* has thus far largely been confined to the development of support institutions rather than actual measures to support small firms. The broader value-added of policies has been limited not only because of the limited outputs but also because the institutions have thus far failed to significantly embedd themselves in the local economy. The networking effect has in effect been absent. The following section seeks to local economic development in Moscow.

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[61] Interview with B.Putilov, 2nd February 1996.

[62] Interview with A.Gorshkaliov, 5th February 1996.

## 7.5. Local economic development in Moscow[63]

### 7.5.1. Economic profile of Moscow

Moscow ranks amongst the regions with highest per capita income in the Russian Federation (see table 7.12. for regional data). Despite above-average declines in industrial production since 1990[64] (Bylov and Lavrov 1996), Moscow has outperformed other growth regions largely due to structural changes giving rise to a buoyant service sector that was estimated to employ about 970,000 people in 1996 (Morvant 1997). The new service sector grew 54.2 percent in Moscow between 1992 and 1994, compared to a Russian average of 7.4 percent during that period (Bradshaw et al. 1998). The financial services sector in particular achieved rapid growth in the capital with, for example, 22 of the largest Russian banks (excepting Sberbank) being located in the capital (WestMerchant Bank 1997). Moscow is one of the principal net donor regions to the federal budget, accounting for 16.8 percent of revenue in 1996 (Gurushina 1997). However, the city budget has been in deficit and the city has issued its own municipal bonds to finance the deficit and to plan future investment, especially in the construction sector. Moscow has also established itself as a leading recipient for foreign investment in the Russian economy (see table 7.13.). According to *Finansovoye izvestiya* (1997), Moscow's share in foreign investment in Russia has continued to grow (to 86.5 percent of the total in first quarters of 1997), reflecting a more solid business infrastructure than in the rest of the country.

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[63] This refers to Moscow city and not the Moscow *oblast'*.

[64] For example, output of Moscow's light industry is estimated to have fallen by 84 percent and more than 90 percent in engineering since 1990 (Rutland 1997).

Table 7.12: Moscow city on figures (1995)

Population: 8,637,000

Population density: 334 per square km

| | Moscow | Russian mean |
|---|---|---|
| **Economic competitiveness** | | |
| GDP (billion roubles) | 144,370 | 127,531 |
| per capita GDP (million roubles) | 17 | 10 |
| industrial productivity (million roubles/ employee) | 74 | 66 |
| **Labour market** | | |
| employed (% of labour force) | 95 | n/a |
| wage levels (1,000 roubles/ month) | 584 | 472 |
| **Investment** | | |
| expenditure for new construction and equipment (% of Russian total) | 10.4 | n/a |
| Foreign Direct Investment (% of Russian total) | 40.4 | n/a |
| **Government finance** | | |
| regional budget deficit (billion roubles) | -1.12 | n/a |
| arrears to the federal budget (billion roubles) | 3,006 | n/a |
| **Social indicators** | | |
| female life expectancy (years) | 72 | 72 |
| male life expectancy (years) | 58 | 58 |
| hospital beds (number per 10,000 population) | 124 | 126 |
| students in higher education (number per 10,000 population) | 520 | 179 |

Source: Centre for the Study of Public Policy 1999, NUPI 1999, Russian European Centre for Economic Policy 1997, own calculations

Table 7.13: Foreign Investment in Moscow City

| | 1994 | | 1995 | | 1996 | |
|---|---|---|---|---|---|---|
| | Amount (mln. US$) | Share | Amount (mln. US$) | Share | Amount (mln US$) | Share |
| Foreign Direct Investment | 155.3 | 28.3 | 951.5 | 50.7 | 844.3 | 40.4 |
| Foreign Indirect Investment* | 33.8 | 6.7 | 360.9 | 39.2 | 3,447.3 | 78.1 |

*includes portfolio investment and bank loans

Source: OECD, 1997, p.127

However, Moscow is not excluded from the general economic decline of the Russian economy. Much of the thriving Moscow banking sector was affected severely by the crisis in summer 1998, with widespread bank closures. The collapse of the stock market and the default of Russia on large parts of its debt has especially scared away portfolio investors that made up a large share of the investment flowing into Moscow. Further decline of the industrial sector is to be expected if bankruptcy proceedings are enforced. According to one estimate, some 80 percent of Moscow's firms are technically bankrupt (Rutland 1997) yet managed to stay in business due to loopholes in the bankruptcy laws and state intervention by the Moscow authorities.[65]

### 7.5.2. Small firm development in Moscow

Moscow has, at 20.0 percent, the highest share of small enterprises in the regions of the Russian Federation. Moscow SMEs accounted in 1995 for 15.5 percent of total employment and 11.4 percent of total output of small firms in Russia (OECD 1998). In addition, 15 percent of Moscow's industrial production and 50 percent of the city's revenues originated from SMEs (*Finansovoye izvestiya* 1997).

Yet by international comparisons Moscow still lags behind in terms of overall density of SMEs and especially in respect of manufacturing SMEs (table 7.11.). Average monthly rates of new firm growth have also slowed from 3.8 percent in 1993 to 1.9 percent in 1996 (Avilova et al. 1996) with the greatest slowdown in construction and innovative SMEs. Despite the more favourable economic environment in the capital in terms of demand conditions, entry of new business has been deterred by a number of factors.[66] Firstly, Moscow SMEs experience greater difficulties in sales than enterprises in other

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[65] In the most spectacular case, the Moscow administration re-nationalised the city's car manufacturer Moskvich, in order to prevent bankruptcy. A special Council on Restructuring of Industry has been set up by the Moscow government in order to find investors for what are *de facto* bankrupt plants.

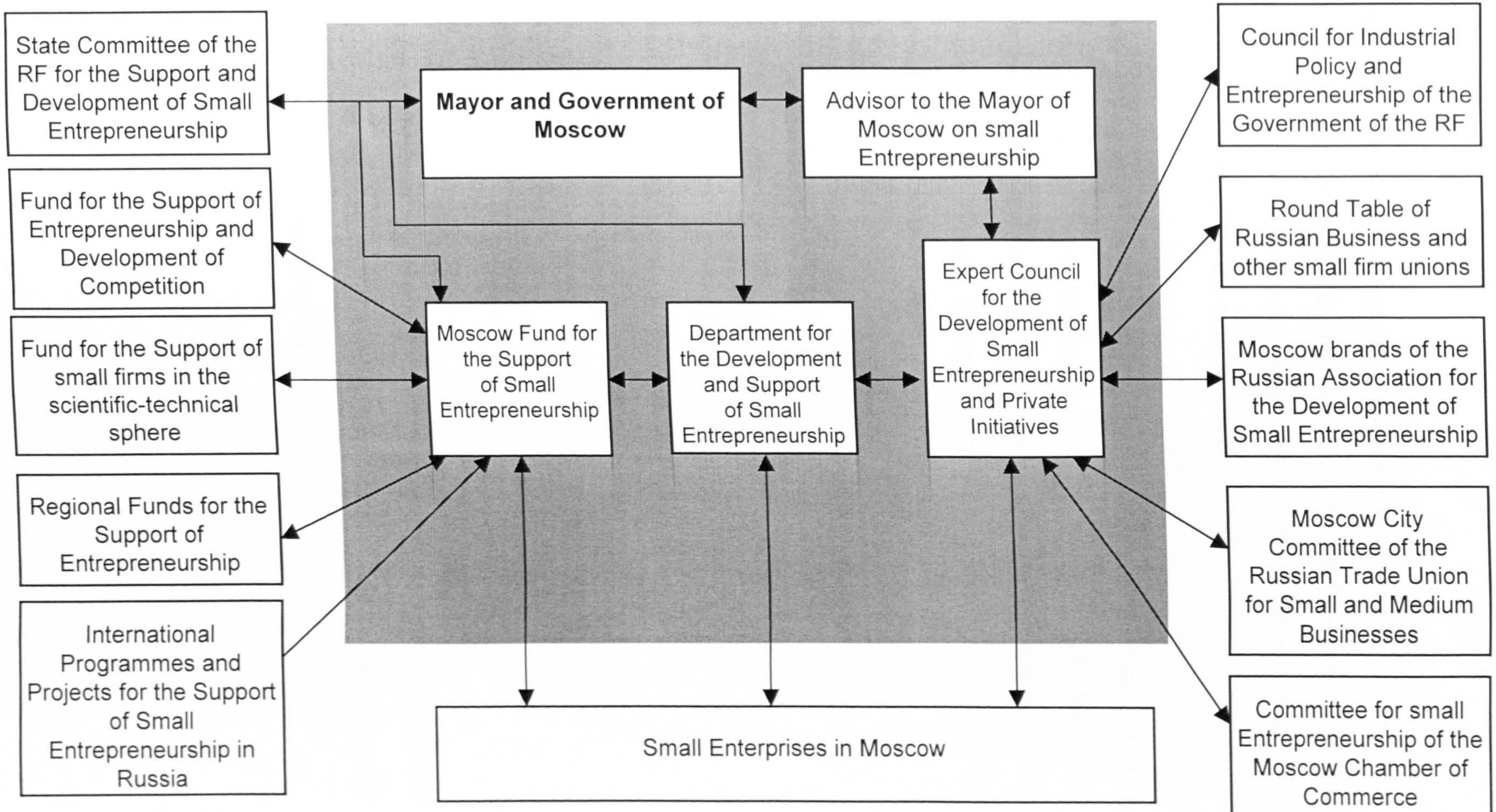
[66] The following is based on surveys carried out by the Russian Independent Institute for Social and Nationality Problems under the TACIS-ACE scheme and own interviews carried out in Moscow in 1995 and 1996.

region, which can be viewed as a consequence of saturation in some markets on the one hand and/or lack of information on market opportunities on the other. Further obstacles to small firm development in Moscow include the lack of investment financing, legal instability and the non-payment crisis, although these factors have been identified in other regions as well. The availability of premises emerges as a more significant obstacle in Moscow than in other regions (Alimova et al.) which in view of the high real estate costs in the capital, is hardly surprising. Moscow SMEs also suffer from high compliance costs. To open a trading stall in Moscow, for example, the entrepreneur needs to obtain a trade certification (valid for half a year), a certification from the architectural bureau, and must pay for an administrative-technical and a sanitary inspection which together totalled US$ 1,500 in 1995 (OECD 1998). These high start-up costs have been used as a vehicle for raising revenue for the local budget. However, they act as a serious deterrent to small firm start-up in the region.

### 7.5.3. Government policy for small firm development in Moscow

Moscow not only boasts the largest population of SMEs in the Russian Federation, it also has one of the most developed support programmes. Since 1993, a number of programmes have been started aiming at supporting entrepreneurship in the capital. The principal institutions involved in SME support in Moscow are outlined in diagram below.

Diagram 7.1: System of SME support in Moscow




Source: Pravitel'stvo Moskvy, 1994

The main aim of the Moscow government's policies for SME support is to create an environment favourable for small firm development including the development and strengthening of the normative-legal basis for small entrepreneurship, the development of an infrastructure for entrepreneurship and the support of investment projects relevant to the city's development (Pravitel'stvo Moskvy 1994 and 1996, interview with Y.Yegorov, 13th April 1994). The policy documents explicitly state that "... the development of small entrepreneurship is not an aim in itself, but a basic condition for the economic and social revival of Russia." (Pravitel'stvo Moskvy, 1994, p.9, own translation). The Moscow government further identifies a number of key sectors for development of SMEs, namely

- agroprocessing
- production of industrial and consumer goods
- the manufacture of pharmaceutical and medical equipment and technology
- development of production, communal and domestic services
- development of catering
- innovative enterprises
- tourism
- construction and capital repairs
- transport

As in the case of Tyumen, the list is so comprehensive as to preclude a distinct sectoral focus. The instruments developed are tailored towards the generally facilitative nature of the aims and objectives.

Table 7.14: Instruments for SME support in Moscow in 1995

| Aim | Instruments | Resources |
|---|---|---|
| Improvement of the normative-legal environment | • proposals for the improvement of federal legislation<br>• proposals for the development of a legislative basis for SME support at the local level | Rb 115.5 million from city budget |
| Provision of information, consulting and training | • establishment of information-consulting centres<br>• establishment of Moscow training fund<br>• training of leaders of Moscow small enterprises including materials<br>• establishment of databank for small entrepreneurs<br>• development of a commercial information centre for agroprocessing<br>• establishment of a research centre on small business<br>• publication of materials relevant to SME development<br>• publication of annual report on small business in Moscow<br>• development of publicity materials<br>• organisation of international seminars, exhibitions and conferences for small entrepreneurs<br>• organisation of the second Moscow Forum on small business and exhibitions<br>• development of Moscow version of "Europartneriat"<br>• establishment of Moscow House of Enterprises<br>• development and establishment of a system of protection for entrepreneurs<br>• establishment of centres for crafts enterprises<br>• establishment of Moscow-British centre for business cooperation<br>• establishment of business incubator<br>• development of entrepreneurship centre in Southern *okrug*<br>• establishment of incubator and financial college in North-Eastern *okrug* | Rb 22.09 billion (of which 550 million from entrepreneurial interest representation, 3.9 million from Moscow entrepreneurs, 700 from federal budget) plus US$ 6 million from international donors (TACIS, World Bank and Japanese government) |
| Financial support and property | • coordination of financial assistance<br>• development of leasing company<br>• establishment of guarantee fund<br>• establishment of non-governmental pension fund for entrepreneurs<br>• development of international trust corporation for investments and guarantees for SMEs in Moscow<br>• development of proposals for international guarantee mechanism for Moscow and Russian SMEs | Roubles 28.5 billion (including 700 million from federal fund, 10,900 from entrepreneurs) plus US$ 60 million from Moscow hard currency fund |
| Support of pilot projects | • financial support for start-ups (special emphasis on foodprocessing) | roubles 84.2 billion including 32,403 of enterprises' own resources |

Sources: *Pravitel'stvo Moskvy* 1994; *Ekonomika i Zhizn'*, 3rd November 1993; *Biznes dlya Vsekh*, nos. 20, 22, 23, November 1995

A number of observations can be made. The programmes appear at first glance to be comprehensive and aiming to overcome duplication of efforts by channelling international donor assistance and co-ordinating measures with the donor community and other business support organisations such as the Chamber of Commerce. However, given the financial weight of the donors, policy is likely be influenced by the agenda of the donor community especially in line with the prevailing neo-liberal consensus. As has been shown in the case of the Hungary, the trend towards private sector institutions for entrepreneurship support aiming at a 'demonstration effect' is not appropriate in the context of transition economies, and has been severely criticised also in Western Europe (Eisenschitz and Gough 1993).

Secondly, the instruments utilised can be divided into 'soft' instruments, including the development of business support institutions ranging from real to financial service providers, and 'hard' instruments focusing on direct financial support to enterprises. The largest spending item of the Moscow government (leaving aside the international donor assistance) is on 'hard' measures. The severely selective[67] approach with which these are utilised, in the absence of a comprehensive sectoral strategy, is problematic since destructive rent-seeking might result. Furthermore, only a small fraction of demand can be satisfied through such an approach. Indeed of 675 applications, only 61 were considered for support in 1996 (OECD 1998).

Thus, the measures do not aid the central aim of small entrepreneurship becoming a way-of-life; rather, it is only for a privileged few. The survey by the Russian Independent Institute for Social and Nationality Problems confirmed that, out of the four regions surveyed, Moscow entrepreneurs had the smallest share of those receiving any kind of real support from the local administration and were also worst informed about government programmes (federal and local) in support of

[67] In 1993, for example, 3 new businesses were financed by the Moscow government.

entrepreneurship (Avilova et al. 1996). This suggests the lack of embeddedness of institutions in the local economy. Whilst institution building and selective intervention is relevant for more mature market structures characterised by a critical mass of small firms, the absence of such a critical mass in Moscow calls initially for a different approach that focuses on the creation of large numbers of new entrants.

The case studies of the two Russian regions have sought to demonstrate that small firm development is an important vehicle for structural change at the regional level in the Russian economy. There are significant variations across the regions in terms of the depth and breadth of small firm development with the richest regions exhibiting highest levels of SME density according to available statistical information. However, even Moscow, which boasts the highest share of total numbers and output of Russian small firms, has not caught up to the levels of small firm sector development of the more advanced transition economies such as Hungary. Furthermore, a dearth of manufacturing and innovative small firms characterises both regional economies.

The governments in the Tyumen *oblast'* and Moscow have both developed small firm policies based around a selective approach and, in the case of Moscow, also a facilitative one focusing on institution building. Given the unsaturated nature of market structures, such an approach is inappropriate as it raises the risk of government failure. The lack of transparency and coordination in the allocation of scarce resources for SME support is a further problem especially in the case of Tyumen *oblast'*. In both case studies, support institutions are weakly embedded in the local economy.

## 7.6. Conclusion

The case studies have sought to shed light on the development of small firms and small firm policies at the local level in Russia and Hungary. The analysis reveals differences in the dynamics of small firm development within and between the

countries in respect of the barriers to entry and development, the factors driving the emergence of small firms and the size and composition of the small firm sector. A commonality between the four regions, however, has the relative dearth of industrial and/or investment-profile small firms. This trend towards the absence of industrial firms therefore might be viewed not as a local problem or issue but rather as a national or even systemic one (see also chapters 5 and 6). This then raises the question about the extent to which local policy-makers will be able to effectively address the situation. Clearly, as was pointed out in the previous chapter, there is a need for a comprehensive small firm strategy at the macro-level in order to tackle some of the generic and/or systemic barriers to small firm development and growth.

Looking at the development of local small firm policies in the two countries, the evidence presented in the case studies suggests that inter- rather than intra-country variations are significant. Thus, both Budapest and SSB, despite differences in the local economic environment and small firm growth, have a semi-private support institution responsible for delivering local economic policies. These agencies share broad objectives in terms of developing local entrepreneurship and promote the growth of small businesses in their respective local economies. Furthermore, the instruments utilised are broadly the same, focusing on financial assistance to start-ups and established companies and providing information and training. The approach taken is also broadly similar with emphasis in the initial phases on the promotion of start-ups and, more recently, reorientations of policies towards established firms. Both local agencies have also taken a market-based approach by focusing their support on enterprises that are likely to be a success, thus aiming at a 'demonstration effect'. Over recent years, the support institutions in Budapest and SSB have also come under pressure to seek clients other than small firms since, with the discontinuation of Phare funding, the agencies have to consider the need for self-sustainability.

There are also striking similarities between the two Russian case study regions in respect of small firm policies. The institutional structures comprising both a financial and managerial arm, are similar in both regions. A key feature of both Tyumen and Moscow is that small firm development is firmly embedded within local government structures rather than devolved to a semi-private institution as is the case in Hungary. The aims and instruments of small firm support broadly coincide in the two regions, although Moscow has traditionally had a larger amount of money at its disposal to support SMEs. Both regions have focused on the development of business infrastructure, like Techno/ or Science Parks and training centres on the one hand and, on the other, have practiced a selective approach towards financial support of SMEs, involving a very limited number of start-ups per year. Lastly, in both of the Russian regions, international donor initiatives for small firm support have run (or are going to, as in the case of Tyumen) in parallel to and outside the local government initiatives, even though Moscow has been keen to foster links with the international donor community. Subsequently, the development of small firm policies in the two Russian regions has been only marginally influenced by Western experiences and models and this will be returned to in chapter 8.

A possible explanation for the strong inter-country variations and weak intra-country differences in small firm policies in the four case study regions lies in the relation between national- and local-level policies. There is little evidence in the four case studies of genuine local initiatives; rather, policy frameworks and policies tend to be developed at the national level and devolved to the local level with only a small degree of adaptation. Budapest and Tyumen are especially good examples of this since their local economic development institutions and policies deviate very little from the national frameworks. In the case of SSB and the Primom foundation, emerging local-level initiatives were subsumed within a national framework as this held the promise of additional funding sources. The case of Moscow is somewhat different in as far as policy development in the city has informed policy-making at the

national level. The outcome, however, has been also an adherence to the national-level model.

This lack of local initiatives poses two main problems. Firstly, as was shown in chapter 6, serious questions have to be raised about the appropriateness and efficacy of the national-level frameworks of small firm support in the two countries. Secondly, the top-down approach to policy-making leaves little scope for addressing local problems in respect of small firm development. While the regions do exhibit some common problems in respect of SME development such as the deficit of industrial small firms, differences in respect of industrial profiles, local institutions and power structures and not least resources at the disposal of local policy-makers warrant a local approach to small firm development. That does not mean that national policies need to be jettisoned. As already outlined, some of the problems in respect of small firm development are generic and/or systemic and require a macro-level approach. These policies at the national level should, however, be complemented by local initiatives tailored to the needs of the local economy and the small firm sector within it, as was outlined in the case studies.

Having compared policies in the two countries at the national and local levels, the following chapter will draw together the findings and compare the policy-development in the two transitional economies with the Western models in order to extrapolate policy recommendations.

# Chapter 8: Local-level policies for small firm support in Russia and Hungary compared: Summary and conclusions

## 8.1. The dynamics of small firm sector development in Russia and Hungary

The initial growth of small firms in Russia and Hungary was explosive in the transition period. Given the contrasting national approaches to transition and differing initial conditions, there have been consequent differences between the two countries in terms of the development of the small firm sector. The most marked difference, as table 8.1. highlights, is in respect of the overall size and weight of small firms in the economy.

Table 8.1: The state of SME development in Russia and Hungary (1995)

| | Hungary | Russia |
|---|---|---|
| Numbers of SMEs | 1,045,367 | 836,000 |
| Density of SMEs (no. per 1,000 population) | 103 | 5.6 |
| Contribution to overall employment (in percent) | 66.7 | 14 |
| Contribution to GDP (in percent) | 49.3 | 12 |

Source: KSH 1996, Kállay et al. 1997, OECD 1998, own calculations

The figures show that Hungary is significantly ahead of Russia in respect of the overall size of the small firm sector and its role in the economy. The reasons for this are partly historical and partly a reflection of the more favourable environment within which firms are operating in Hungary. In Russia, the legacy of central planning and the resulting dominance of the large firm sector, combined with the deep and prolonged recession, have slowed the emergence of small firms.

Against these differences, however, the Russian and Hungarian small firm sectors also exhibit some striking similarities. Firstly, a pre-transition second economy existed in

both countries as a result of reforms under the central planning period that aimed to alleviate the rigidities of a first economy dominated by large state-owned enterprises. In both cases the second economy comprised *de facto* private small firms (Roman 1989, Jones and Moskoff 1991). According to some surveys, these pre-transition small firms have emerged as the powerhouse of the new small firm sector in Central and Eastern Europe (Webster 1992, Charap and Webster 1993) since they have been able to exploit quasi-monopolistic positions in the unsaturated market structures characterising the command economy period.

Secondly, the Russian and Hungarian small firm sectors both exhibit structural weaknesses. In both cases, manufacturing and science-based SMEs are relatively under-represented. In contrast, the trade and services sector carries the greatest weight in terms of the numbers of SMEs and has experienced the most rapid growth. This is a typical feature of SME development in the region. SMEs are seen as an important vehicle for structural change during transition since the service sector under socialism was very weak and under-developed (Bradshaw et al. 1998, Hanson 1996). Furthermore, the transition-specific economic conditions in respect of absent and/or underdeveloped markets and a macro-economic environment in flux, are not favourable to the development of 'investment-profile' small firms. Trends of 'overtertialisation', that is the 'push' towards service sector activities in the light of deindustrialisation, are not uncommon in transition economies, as segments of the service sector face the lowest barriers to entry. Nevertheless, these activities *can* serve as an important mechanism for capital accumulation, as the case of China has shown (Goldman 1994): the profits made in trading and retailing were re-invested, leading gradually into more capital-intensive areas of economic activity. However, there is little evidence of such virtuous activity in the two East European economies observed. Tschepurenko (1994), on the basis of survey evidence in the Russian Federation, showed that twice as many entrepreneurs switched from production to trade compared to changeovers from trade to production. Moreover, much of the capital generated by petty trading activities in Hungary has been

channelled into property speculation, consumption or sent abroad (Tchernina 1996). In Hungary, small firms are competing in the increasingly crowded tertiary sector where profits are low, thus limiting the potential for re-investment. These over-crowded market structures are sustained through the persistence of 'barter-corrupt-cartel-ridden' forms of organisation (Sik 1994) that lead to the kind of low-equilibrium trap described by Gabor (1997). The picture is not dissimilar in Russia. Some sectors and subsectors such as trade and retail appear to be heavily populated, especially in the capital Moscow, as barriers to entry have been removed. In the periphery, however, even trade and service small firms might be lacking, as was shown in the case of Tyumen *oblast'* that exhibited a relative deficit of SMEs in all sectors of activity.

Thirdly, in both countries significant regional variations in small firm development exist, with a distinct centre-periphery dichotomy. Both Moscow and Budapest constitute centres with a high level of SME activity, whereas peripheral regions, especially those that have inherited mono-industrial structures, have fallen behind national averages. There exists, furthermore, a strong correlation between per capita regional incomes and the density of SMEs (see chapter 7). This can be viewed as evidence of the operation of demand-pull factors as a determinant of SME activity. Regional differences in the extent to which demand 'pull' factors are in evidence are substantial. Szabolcs-Szatmár-Bereg (SSB) is illustrative of a region characterised by the relative absence of 'pull' factors. Demand conditions are depressed as a consequence of exceptionally high unemployment levels and other unfavourable macroeconomic conditions in the region (see chapter 7). As was demonstrated in chapter 7, the absence of favourable demand conditions is in itself a considerable barrier to entry and growth of small firms in SSB. In Budapest, Moscow and Tyumen, demand factors arising from the presence of large firms and foreign investors and the added 'capital bonus' in the cases of Moscow and Budapest, contributed to the emergence of new small firms, not in production, but in the trade and services sector (Futo and Kállay 1994, de Melo and Ofer 1994, Belova et al. 1994). This trend gave rise to the phenomenon whereby, for example, consumer goods

as well as product inputs were increasingly obtained from lower cost and perceived higher-quality suppliers from abroad (Bartlett and Hoggett 1994, Belova et al. 1994, Okolicsanyi 1993). However, continuing trade liberalisation and foreign competition, accompanied by declining industrial output, unemployment and austerity measures, have increasingly led to a situation of internal and external demand constraints where entrepreneurs are finding it difficult to market their products not only abroad but also in the domestic market (Futo and Kallay 1994). Hence, demand 'pull' factors are of a somewhat transient nature linked to the initial stages of transition.

A fourth similarity is that transitional reforms and enterprise restructuring in the regions have been accompanied to differing degrees by increases in the level of unemployment. Hence, it could be assumed that unemployment is a key factor in the emergence and development of a small firm sector in transitional economies. Yet, research by Bartlett and Hoggett into small firm development in Hungary, Bulgaria and Slovenia concluded that "...unemployment is not a major source of entry into entrepreneurship in these economies" (Bartlett and Hoggett, 1994, p.5) since a significant percentage of the business people interviewed had not previously been unemployed. However, whilst unemployment within the transitional economies has risen as a result of the reform process, many enterprises remain reluctant to enforce redundancy programmes and continue to seek state support to retain low productivity workers (Alfandari et al. 1995, Standing 1996). This inflates the extent of "hidden unemployment" within the economy rather than conventional joblessness (Gendler and Gildingersh 1994). Data from Russia in the mid-1990s suggest that around one third of its industrial workforce could be categorised as "hidden unemployed" (Williams 1994, see also Standing 1996 and Russian European Centre for Economic Policy 1999). Thus it seems reasonable to assume that conventional unemployment would not feature as a reason for establishing a new business. Rather, it would express itself in what Boeri (1994) terms "direct job-to-job shifts". Tschepurenko (1993) points towards the emergence of "Unternehmer gegen ihren Willen" (entrepreneurs against their will) as a consequence of insecurity and

instability of large enterprises. Gimpelson (1993) also highlights job security concerns in large enterprises as a cause for job shifts.

In addition, however, better working conditions, higher levels of job satisfaction and higher pay are cited in surveys as reason why the new private sector has been successfully attracting highly educated and skilled workers (Gimpelson 1993, Gimpelson 1993a). This is evidence of the existence of 'pull' factors. Hence, the Russian experience suggests that what could be termed 'hidden unemployment push' factors may be a significant aspect of small firm dynamics in transitional economies, though 'pull' factors can also be influential. Similarly, in Hungary (as was shown in chapter 5), 'push' factors relating to the lack of adequately remunerated wage-employment in the large firm sector have led the emergence of self-employment in small firms. In addition, the possibility of extra earnings in the small firm sector have 'pulled' into existence many new firms, whose owners sought to complement their incomes from wage-employment and/or pensions with incomes from small business activities (Czako and Vajda 1993).

Aside from these 'push' and 'pull' factors, small firm development in both countries is also characterised by what Futo and Kállay (1994) termed 'emancipation'. An important dynamic observable in both countries is the process of embourgeoisement which had been interrupted during the central planning period (Gabor *1994*, *Ageev et al. 1995*, Radaev 1993). Liberalisation of the economies has resulted in explosive small firm growth not only because of economic factors but also complex sociological, political and legal ones (Tschepurenko 1994). Thus, "...the resurrection of the small business sector is part of the creative self-liberalization process that saw the birth of countless local governments, parties and civil organisation." (Futo and Kállay 1994, p.19). One could argue at this juncture that this provides further fertile ground for analysing differences in the development of small firms in Russia and Hungary given the lesser progress in the development of civil society in Russia. Such analysis, however, is beyond the scope of this thesis.

Having considered the commonalities and differences in terms of small firm dynamics in the two transition economies of Russia and Hungary, the following section is seeking to make comparisons with the West European models (as outlined in chapter 3) before turning to policy implications.

## 8.2. Small firm sector dynamics in Russia and Hungary: parallels to Western European models?

There are both similarities and differences between, on the one hand, small firm sector development in Hungary and the Russian Federation, and, on the other, that displayed in the West Midlands model. In terms of similarities, as has been argued in the preceding section, 'push' factors related to the rising unemployment (conventional and hidden) consequent on the contraction of the large firm sector, are influential in explaining the emergence of a small firm sector in regions of both Russia and Hungary. Similarly, unemployment 'push' factors are also a key determinant in the rise of small firms in the West Midlands area (see chapter 3).

Secondly, a similarity to the West Midlands model, and thereby a key difference to the Mondragon and Emilian industrial district model, appears in respect of networking activity of small firms. The existence of closely-integrated clusters of small firms exhibiting a high degree of co-operation and competition has been a salient feature of small firm development in the 'industrial district' model (Brusco 1982, Pyke 1992). An indicator of such networking activity can be seen in the degree of inward and outward subcontracting by the small firm sector. The evidence from Hungary suggests that subcontracting is an increasing feature of small firm development (Bartlett and Hoggett 1994, Futo and Kállay 1994, Fülöp 1994). However, as Neumann (1993) notes, subcontracting is often contingent upon the existence of large firms and hence does not exhibit the degree of interdependence of small firm networks shown in the Emilian

industrial district model. Furthermore, Gabor (1997) points to the fragility of the links between large firms and the small firm sector as large firms under increasing economic pressure cut the ties to their small business partners first. Such behaviour is reminiscent of the 'arms-length approach' towards supplier relations that typify the West Midlands model (Bateman 1997).

A third similarity between small firm sector development in the two transitional economies and the West Midlands lies in the strategies that small firms adapt in order to compete with each other and larger firms. In Hungary, as Sik (1994) and Gabor (1997) have demonstrated, the viability of the small firm sector is dependent on either the persistence of cartel-type market structures or the exploitation of unregulated labour markets and especially sweated labour. Similarly in Russia, small firms compete either by escaping from the regulatory constraints of the official economy (that is the shift into the 'black' economy) or by virtue of their parasitic links with large firms (Gimpelson 1993, Ioffe et al. 1996, Afanassieva and Couderc 1998). In both transition economies, therefore, small firms are following a 'low road' to competitiveness, a path that also typefies small firm development in the West Midlands model.

There are, however, important differences between the two transition economies and the West Midlands model. Firstly, the small firm sector in both Russia and Hungary is characterised by its relative 'newness', that is, small firms have only emerged to any significant extent over the last decade. In contrast, small firm development in the West Midlands has spanned many decades and as such is much more embedded in the local economic culture. Secondly, small firm development in the West Midlands (at least in the recent past) has taken place in the context of a relatively stable macroeconomic environment and a well-established legal and regulatory framework. Both Russia and Hungary, however, exhibit degrees of macroeconomic disequilibrium (albeit varying) and weaknesses in respect of the legal framework regulating business activity. Small firm development in the two transition economies, therefore, takes place under

considerably more uncertain environmental conditions. Thirdly, the West Midlands model is characterised by both 'mature' and 'saturated' market structures in respect of small firm activity (see chapters 3 and 4). As was demonstrated in chapter 5, Russia continues to be largely characterised by 'unsaturated' market structures. Hungary also, aside from overcrowded segments in the trade and services sector, has not yet reached 'mature' market structures in industry. Thus, the two transition economies, in contrast to the West Midlands model, are characterised by the lack of a critical mass of industrial small enterprises. Lastly, there are important local economic and structural differences between the East European case study regions and the West Midlands.

Table 8.2: Local economic development: West Midlands and the case study regions in Eastern Europe compared

| | West Midlands* | Budapest** | SSB** | Moscow+ | Tyumen++ |
|---|---|---|---|---|---|
| per capita GDP (US$) | 16,393 | 7,326 | 2,265 | 3,726 | 7,452 |
| unemployment (in %) | 6.4 | 5.5 | 11.8 | 6.2 | 2.9 |
| industrial structures | diversified | diversified | agriculture and food processing | diversified | oil and gas |
| location | central | central | peripheral | central | peripheral |
| economic growth | positive | positive | positive | negative | negative |

* figures for 1998
** figures for 1997
+ GDP figures for 1995, unemployment figures for 1998
++ figures for 1995
Source: Centre for the Study of Public Policy 1999, KSH 1999, Advantage West Midlands 1999, Shulyakovskaya 1998, own calculations

Whilst the figures in table 8.2. have to be interpreted cautiously, they nevertheless highlight important differences at the local level in terms of economic development (and therefore the context within which small firm development occurs) between the West Midlands and the East European case studies. Most strikingly, even though the West Midlands ranks below the UK average in terms of per capita GDP, it nevertheless outpaces even the richest of the East European regions (Tyumen) by a significant

margin. The economy of the West Midlands region is also fairly diversified, comprising of old industries such as ceramics and automotive, new technology-based industries, an expanding service sector and agriculture in rural pockets of the region. Amongst the Eastern European case studies, only the two capital cities bear resemblance to this kind of structural diversity as they are home to mixture of old and new industries as well as a developing service sector.

Overall, the West Midlands economy and small firm development within it divert significantly from the trends observed in the four case study regions. Similarly, when comparing the Eastern European regions to the Emilian industrial district model and the Mondragon model, important differences appear.

A key feature of the Emilian model lies in the trust relationship and common value systems underpinning network interactions (Pyke 1992, Putnam et al. 1993, Becattini 1990). In the Hungarian case study areas there was a distinct lack of such trust relationships among entrepreneurs (see chapter 7), although Kuczi (1993) reported on the existence of social capital in villages in the Pest region of Hungary. Clearly, more research is necessary to clarify such regional cultural patterns. Moreover, inter-firm linkages amongst small firms, as was argued in chapter 5, are weak and do not exhibit cooperative forms of interaction along vertical and horizontal lines as observed in the Emilian industrial district model. The relations with large firms, as was argued above, are largely dictated by large firms' need to increase flexibility and reduce costs. Thus, the 'high road' to competitiveness, so typical of the Emilian model, is not being pursued by Hungarian firms.

In Russia, the dependent nature of subcontracting has been as pronounced as in Hungary (Belova et al. 1994, Charap and Webster 1993, de Melo and Ofer 1994). As was shown in chapter 5, the establishment of links between small and large firms is often part of large firms' strategies of asset-stripping. Subcontracting relationships are furthermore

impeded by the phenomenon of inter-enterprise arrears that constitute an important mechanism for the maintenance of the *status quo* in the Russian economy as it effectively disperses the costs of value-subtracting entities over the whole of the economy (Gaddy and Ickes 1998). An important feature of Russian small firm development can be seen in the relative importance among entrepreneurs of informal networks, which are characterised by their illegal and corrupt nature and which are frequently Mafia dominated (Knaack 1996)[1]. According to Charap and Webster "...practices that would raise legal and ethical questions in the West were framed as 'good connections' which were widely cited as a key to success. The exchange of favours of significant commercial value,... was normal practice even between private businessmen." (Charap and Webster, 1993, p.311).

Whilst we can observe the emergence of proto-network type linkages in the regions in Russia and Hungary, they are essentially of a different quality than those observed in the industrial district model. The key element of trust as an underpinning and cementing agent for the functioning of networks appears to be largely absent in the regions observed. Furthermore, there is little evidence of embeddedness of small firm networks as relations tend to be short-term-profit-oriented based on an 'arms-length' approach, thus, as was noted earlier, corresponding more closely to the West Midlands model (Curran and Blackburn 1994).

The development of intra-firm networks as found in the Mondragon model has not been observed in the case study regions either. The development of co-operatives during the Gorbachev period was a convenient cloak for *de facto* private ventures and liberalisation

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[1] A conscious effort has been undertaken by the Russian Association of Small Enterprises to promote characteristics such as reciprocal honesty and mutual trust in inter-enterprise dealings by its members. In association with the Russian Orthodox Church, the Russian Chamber of Personality honours in a public ceremony entrepreneurs respecting old codes of conduct dating back to 19th century Russian business practice. Albeit an alien concept to the Western observer, it illustrates not only that the problems of corruption are being recognised but also that maybe a new type of business culture is evolving attempting to deal with the issues (interview with Y.Malykhin, 15th April 1994).

and privatisation, once underway, have led to a decline in co-operatives in Russia as they turned into private companies (Nuti 1992). A similar trend has been observed in SSB where particularly agricultural co-operatives which were initially formed to avoid nationalisation were being dissolved and run as private sector organisations.[2] However, developments in the mid-90s indicated that the co-operative format had the potential to experience something of a renewal as a result of the transition process and the possibility of genuine enterprise autonomy. The privatisation process in Russia and Hungary was leading to the creation of a substantial number of worker buy-outs and worker-shareholders and these new enterprise formats were thought to be able to tap into the remaining reserves of collective energy and will-power(EBRD 1997).[3] However, more recent research suggests that, far from being a model enterprise format, insider-controlled enterprises (that is enterprises under worker- and/or management-ownership) performed significantly worse than other ownership formats (outsider controlled enterprises) (Chance 1999, Filatotchev et al. 1999). The reason for the relatively poorer performance of insider-controlled enterprises was seen in the weak incentives to depart from the *status quo* (Alfandari et al. 1995) as well as the problems associated with corporate governance and finance which delayed the initiation of painful restructuring (Filatotchev 1997). Thus, there is little evidence to suggest that mutually supportive intra-enterprise links based on worker-ownership along the lines of the Mondragon model are emerging in Eastern Europe.

One of the key findings emerging from the comparison of the East European case study regions and the three West European models is the *distinctiveness* of the small firm development in Eastern Europe. As was noted at the beginning of this section, there are some parallels to the West Midlands model in terms of factors underlying small firm

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[2] Interview with T.Hagymasi, 22nd September 1993.

[3] The emergence of worker-ownership through privatisation was observed during a research study by the writer [funded by the European Union Tacis Programme (T94-1052-R)] to the Tula region in Russia. One of the large diversified enterprises in the region, *Tulamashzavod*, was bought out by its workers and restructuring has resulted in the emergence of strategic business units not dissimilar to the Mondragon case. However, in the absence of reliable performance indicators, no conclusions can be drawn as to how successful this experiment with worker-ownership has been.

sector dynamics, 'arms-length' relations to large firms and the pursuit by small firms of the 'low road' to competitiveness. However, the development of small firms in Eastern Europe differs qualitatively and quantitatively from all three West European models. Qualitatively, small firm development in Eastern Europe is a relatively new phenomenon and is driven by a mixture of 'push' and 'pull' factors as well as a trend that has been termed 'emancipation'. Furthermore, the small firm sector in Eastern Europe exhibits a high degree of fragmentation and atomisation and inter-enterprise linkages that do exist are not based on a virtuous combination of competition and cooperation. In quantitative terms, the small firm sector in the Russian Federation and, to a lesser degree in Hungary, has not yet reached the maturity observed in the West European examples. In particular, a critical mass of industrial small firms is lacking in the East European case study region as the adverse external environment and structural change have favoured entry of small firms into the tertiary sector. The qualitative and quantitative uniqueness of the East European case studies in terms of small firm development carries important implications for policy transfer of 'best practice' from the West to the East. The following section will summarise the extent to which such policy transfer is practiced and evaluate its relevance to the East European scenario.

## 8.3. Local-level small firm policies in Russia and Hungary

Support for small firms has emerged as a main agenda item of local economic policies in Eastern Europe. A number of common denominators characterise the emergent policies in Russia and Hungary. First, small firm policies are essentially pragmatic, based around the identification of 'problems' that small firms are experiencing and the subsequent development of instruments to alleviate these. This invariably involves forms of financial support ('soft' loans, loan guarantees and the like), training schemes, consultancy and technology parks or incubators. Thus, small firm policies have largely targeted inputs rather than pursuing sectoral strategies or focusing on types of businesses. Second, there is an underlying assumption that, once remaining

administrative barriers are removed and market imperfections are ironed out, a competitive small firm sector will emerge. This assumption emerges from the neo-liberal doctrine that has pervaded many aspects of policy-making in the region (Gowan 1995, Lavigne 1999). Third, institution-building has been a central aspect of small firm policies in the case study regions of Russia and Hungary. In both countries a plethora of business centres and self-help organisations, with and without governmental assistance, emerged in order to provide and institutional support network to small firms.

Looking at these broad characteristics, the similarities to the UK's mainstream local economic development policies are striking (Eisenschitz and Gough 1993). In the case of Hungary, the common features with UK policies extend even further. The network of LEAs was explicitly modelled on the UK system of Local Enterprise Agencies and to some extent the Training and Enterprise Councils (TECs) (Gibb and Haas 1996, see also chapters 6 and 7)[4]. These forms of public-private partnerships are an essential ingredient of the neo-liberal consensus prevailing in UK local economic policies (Bateman 1999). The broadly unselective approach towards small firm sector support as practised by the Hungarian LEAs has also been typical of the UK experience in the 1980s. Furthermore, the increasing pressure exerted by funding bodies such as Phare on the Hungarian LEAs to 'stand alone' and pursue profitable activities is reminiscent of the UK experience (RIPA International and MACON 1997, Gibb and Haas 1996). The adoption of UK-style policies in Hungary has been crucially influenced by two factors. First, small firm sector development constitutes one of the key targets for international technical assistance in the region and Hungary was one of the first countries to tap into the European Union PHARE programme. The UK-based consultancy company Coopers and Lybrand won the PHARE SME development contract for Hungary, and proceeded to implement a policy framework with which it was familiar (see chapter 6). Second, the

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[4] A recent report on the development of the LEA network, for example, suggests avenues for the attainment of self-sustainability based on the UK funding experience (RIPA International and MACON 1997).

UK experience with its essentially non-interventionist, non-governmental character fits into the broader economic policy framework that leans heavily on neo-liberal prescriptions (Gowan 1995, Lavigne 1999, Bateman 1999).

There is, however a crucial difference between the Hungarian system of LEAs and the UK experience. Whilst in the UK local enterprise agencies developed essentially in a bottom-up fashion with fairly strong ties between the public and the private sectors (Gibb and Haas 1996), the Hungarian LEAs were largely shaped in a top-down fashion by a central agency (the MVA). This top-down approach is problematic for two reasons. Firstly, it does not leave sufficient scope for the development of institutions and policies that are tailored to the salient conditions prevailing in the local economy. The uniformity effectively limits local adaptation. Secondly, the top-down approach carries the risk of creating disembedded institutions and policies. As was demonstrated in the case of SSB and, to a lesser degree in Budapest (see chapter 7), local firms and the local self-governments which had become involved in small business support in the late 1980s and early 1990s, felt sidelined as the LEA structure emerged. Subsequently, the links between the support institutions and major stakeholders in the local economy weakened. Overall, the case studies in Hungary showed that opportunities for broader value-added of policies through networking effects diminished as result of the type of institutions and policies adapted.

The policy approach adopted in the Russian Federation deviates in some aspects from Hungary and, *ipso facto*, the UK model. Similar to Hungary, there is a strong element of centralisation of policy-making as the framework for small firm policy was developed by the central government with the responsibility for implementation handed down to local governments. However, the local government 'ownership' of policies represents a departure from the neo-liberal concepts so prevalent in Hungary and the UK; these envisage the withdrawal of government from meso-level policies amongst others. However, in the case of Moscow, a move towards a lesser degree of government

intervention was already evident as the Moscow government started to develop links with internationally-funded SME support institutions in the region which are modelled on the concept of non-governmental business support centres (Pravitel'stvo Moskvy 1994). To what extent these links will weaken local government 'ownership' of policy initiatives remains to be seen.

A second key difference to Hungary emerges in respect of the overall approach towards small firm policy in Russia. Whilst some aspects of the Hungarian policies in terms of the development of support institutions with a non-selective approach are in evidence, the Russian SME support programmes, in terms of resource allocation, are firmly concentrated on selected pilot projects. These pilots, through demonstration and multiplier effects, are expected to exert a strong 'pull' effect on small firm development in the region. Although selective, these policies in the Russian regions differ substantially from the Western example of a qualitative approach. In Mondragon, the selectivity was practised by the a group of companies (the Mondragon Cooperative Complex) rather than by an outside organisation. Selectivity from within, whereby firm insiders select and support new ventures for start-up and/or growth, narrows information asymmetries that can give rise to adverse selection. Outsiders (local government officials, for example, or banks) often lack relevant and complete information and are therefore limited in their ability to identify firms with growth or survival potential (Storey 1994, Mole and Hassall 1999). The Mondragon approach was furthermore strongly sectorally focused, aiming to build upon existing competitive strengths within the group. In the two Russian case study, a sectoral bias is less easily discernible and selection remains largely untransparent.

The Russian departure from the UK and, *ipso facto*, from the Hungarian approach is partially pragmatic and historically-determined. Although Russia has also been in receipt in international donor assistance, the funding under the TACIS programme has been much less generous than under PHARE, reflecting priorities in European Union

external policies in respect of EU accession (Gower 1997). That in turn, however, has facilitated greater scope in the development of 'home-spun' rather than imported policy. Moreover, the relative lack of funding for SME projects in the Russian Federation has been used by policy-makers to rationalise the emphasis on a selective approach.[5] Government intervention of the selective nature practised in the Russian regions is furthermore strongly reminiscent of central planning albeit involving a shift from 'gigantism' to 'minituarism'. Despite the shock therapy approach briefly attempted in 1992, Russian economic policies have conformed less to the neo-liberal doctrine than Hungarian ones.

In preceding chapters, it has been argued that the policy approaches adopted in the two countries are inappropriate as they do not sufficiently take account of the specificities of local market structures (see chapters 6 and 7). The indiscriminatory, non-sectoral approach as practised by the Hungarian LEAs does not remedy the atomisation of small firms in the over-crowded tertiary sector as new entrants further reduce available profit opportunities. The danger is that the low profitability of the sector effectively freezes all participants in a state of under-development. Rather than being able to break into new markets, develop new technologies and introduce new products, the undercapitalised small firm sector tends to atrophy over time. A small firm sector following the 'low road' to competitiveness is being created. In such a scenario, inefficiencies associated with displacement and deadweight effects are also evident (Storey 1994). Neither does the approach practiced by the Hungarian LEAs effectively address the need to develop a critical mass of industrial small firms as the exclusion of a sectoral bias and a quasi-market approach have failed to lower entry barriers sufficiently to allow for the mass entry of key new growth and technology-oriented firms.

The Russian regions' approach is open to criticism in as much as it does not effectively facilitate the shift from 'unsaturated' to more 'mature' local market structures. A small

[5] Interviews with Y. Yegorov, 13th April 1994 and O.Matyushenko, 1st February 1996.

number of new entrants does not lead to significant reductions in monopoly power (Ickes and Ryterman 1992). The evidence suggests that existing firms guard their market share by effectively erecting barriers to further entry or by entering into associations/market sharing agreements with new entrants. There are also instances of entrepreneurs attaching themselves to bureaucratic structures in order to liquidate existing competition and prevent new entry (Hanson 1993 and 1994).

The question that arises from the above analysis is whether there is an alternative approach to small firm policy and what its the broad parameters are.

## 8.4. Alternative approaches to small firm development in Russia and Hungary: a future research agenda

A possible policy alternative for Russia and Hungary could be drawn from policy instruments and approaches used in the Emilian industrial district model. A key ingredient of the Emilian model, co-operation and competition fostered judiciously by local governments, businesses and trade unions, could be viewed as relevant to the East European setting for a number of reasons.

First, such policies at the local level in Emilia Romagna have been successful in the initial stages in promoting the mass entry of mainly industrial small firms, thus stimulating the emergence of a critical mass and clusters of small firms (Perulli 1990). This is an appropriate strategy in the initial stage of small firm sector development in the transition economies as it alleviates the relative deficit of industrial SMEs and the associated unsaturated market structures (Schmitz and Furlong 1995). It furthermore addresses the issue of demonopolisation of industrial structures that is an essential prerequisite for competitiveness (Stiglitz 1994, McDermott and Mejstrik 1992, Porter 1998). Moreover, this type of sectorally-based mass entry approach reduces the possibility for destructive rent-seeking which has been highlighted as a particular

problem in the Russian case. Since the quantitative approach is applied within an environment that is characterised by a lack of SMEs, inefficiencies associated with deadweight and displacement are minimised.

However, this sectorally-based quantitative approach is crucially dependent on a number of factors. First, international experience suggests that the costs associated with selecting new sectors (in which new small firms are being promoted) are high and inefficiencies are likely to arise. Ideally, the promotion of mass entry should focus on proto-industrial or industrial structures already prevalent in the region. This might involve the reconstruction and development of supply chains with both small and large firms in the region (Bateman 1997). Porter (1998) highlighted the existence of local related and supporting industries as well as sophisticated local buyers as key determinants in his 'diamond' theory explaining competitive advantage. In chapter 7, possibilities for supply chain development related to, for example, oil and gas enterprises in Tyumen *oblast'* or wine and food processing in SSB were tentatively identified. However, further research is necessary to identify the potential for supply-chain links.

Second, appropriate instruments need to be developed at the local level to facilitate mass entry. The Emilian and Mondragon experience highlight the importance of local financial institutions, particularly of the co-operative format, in overcoming financial resource constraints. The provision of premises is another useful instrument especially in the light of the frequently extensive local supply resulting from the contraction of the large firm sector (Alimova et al. 1995). Third, local governments have to be a key stakeholder in that approach. The marginalisation of local governments in the UK and again in Hungary introduced pressures for fee-based services and neglected wider economic externalities arising out of small firm development. Local government ownership of policy is essential in order to allow for balanced economic and social development within the region. Sceptics are distrustful of this kind of involvement as

local governments are often depicted as *being incompetent* and corrupt. Yet a closer examination of the personnel in the Hungarian LEAs, for example, revealed that many of the key positions were held by former government employees. The actual personalities therefore matter little in relation to appropriate incentive structures that need to be developed. Furthermore, as Chang (1996) has argued, destructive rent-seeking activities by governmental structures can be alleviated by promoting political competition, by introducing policies that limit the scope for rent-seeking and by greater transparency in decision-making. Nevertheless, the widespread practice and acceptance of corruption in Russia poses a formidable obstacle to governmental involvement and this point will be revisited below.

Once the relative deficit of industrial SMEs has been alleviated, a second stage of small firm development policy might address the fragmentation of the sector through a greater focus on the promotion of local-sectoral co-operative schemes. The role of the local government would be that of a network broker that seeks to enhance the competitive strengths of the network. The emphasis here would be on technological upgrading within the existing clusters along the 'high road' of competitiveness involving upgrading of factors of production (Pyke and Sengenberger 1992, Porter 1998). Relevant instruments and mechanisms to attain that have been outlined in chapter 3.

The approach that is proposed here, combining industrial policies with the development of competitive market structures at the local level, takes into account not only international experience but also some of the specificities of small firm development in the case study regions. The experience of such policies in West European regions is relevant to the East European context, because they represent, as one Hungarian specialist has argued,

> ...'pro-embourgeoisement' industrial policies in the country's slump-ridden areas as opposed to a protectionist policy serving to conserve large enterprises; policies

> that may prove acceptable for the diverse political forces representing the civil society. In addition, they could serve as counterpoints to excessive macro-policy-centredness....And, finally, they may also act to prevent Hungary from slipping into a new kind of duality: the simultaneous presence of a highly competitive private economic sector dominated by foreign capital and a poorly performing domestic sector representing an obstacle to modernization....(Gabor, 1994, p.12)

However, there are a number of impediments to the realisation of the approach suggested here. First, industrial policy implementation as proposed here should be viewed as a process based on consensus between the major stakeholders in the process. The legacy of central planning, however, imbues the concept of industrial policy with notions of top-down planning of the *gosplan* variety. This is reflected, for example, in the SME support programmes of the Russian Federation (chapters 6 and 7). Therefore, cultural-historical factors might deter effective application. Second, the scope for local policies might be curtailed by the national policies that influence, for example, local government finances (see chapter 6). Therefore, as was argued in chapter 7, local-level small firm policies should be developed in the context of a national industrial policy framework incorporating appropriate macroeconomic policy instruments. Such an approach, however, is constrained in the short to medium-term as Hungary's economic policies are geared towards meeting the accession criteria including adoption of the *acquis communautaire*. Russia, on the other hand, in the fallout of the 1998 crisis and the forthcoming parliamentary and presidential elections, has experienced frequent changes in government and subsequent disruptions of policy-making. In the current state of crisis management, it is hard to imagine Russia's leaders developing the kind of coherent industrial policies envisaged here. Third, the proposals made here assume that local governments realise the importance of SMEs and are willing to support them. That might not be the case in regions where local governments focus primarily on restructuring of the large firm sector as in Tyumen for example. In addition to the constraints on the *transfer* of the kind of 'best practice' policies of Emilia Romagna to Eastern Europe, questions have to be raised about their *transferability*. As was

highlighted in chapter 3, an essential ingredient of the Emilian and Mondragon models are common value-systems based on notions of co-operation and trust in the local community. Therefore the shape and style of implementation of the kind of policies listed above would undoubtably need modification and adaptation to the local communities in Eastern Europe where notions of civil society are very different. Therefore, the policy synthesis presented above should be viewed as an agenda for future research and discussion rather than a hard policy prescription.

From a theoretical perspective, the proposal presented here departs from the neo-liberal consensus that has permeated policy-making in Eastern Europe. In the light of the failure of market mechanisms to bring about 'mature' market structures in respect of small firms, a more active role for governments is indicated. As such, the thesis draws on the institutional school of thought that recognises the need for private ownership and macroeconomic stability, yet emphasises the role of government in bringing about restructuring. The research has sought to inform the theoretical and policy debates by stressing the potential relevance of a local variant of institutional economics - the industrial district thesis - to countries in Eastern and Central Europe as it recognises diversity at the regional level and provides a bottom-up alternative to the neo-liberal framework at the national level.

# Appendix 1: Interviews

In conducting the research for this thesis, 77 interviews were carried out with policy-makers, small business owners and academics in Eastern Europe (see chapter 1 on explanation of methodology). The interviews were conducted between 1993 and 1997 during a number of field study visits to the regions. Below follows a list with details on the interviewees. Titles and affiliations are given for the time during which the interview took place and relate to the main occupation that the interviewees wanted to be identified under (see chapter 1 on definition of key informants). The titles and affiliations were mainly taken from business cards provided during the interviews, when no business cards were given, a description of the interviewee follows. When business cards were transliterated from Russian, the standard English phonetic transliteration was used.

Hungary:

| Name | Position and institution | Date(s) of interviews |
|---|---|---|
| J. Attwater | Consultant, PRIMOM-Lancashire Consultants | 8th August 1993 |
| J. Várkonyi | Senior advisor, IPOSZ | 15th September 1993 |
| I. Maróczi | Project manager MVA, Budapest | 17th September 1993, 23rd November 1993 |
| L. Kállay | Foundation for Market Economy and later Director of the Institute for Small Business Development, Budapest | 16th September 1993, 30th July 1997 |
| P. Futo | Foundation for Market Economy | 16th September 1993 and 21st July 1997 |
| J. Burns | Programme Director CEC-PHARE SME programme, MVA, Budapest | 16th September 1993 |
| L. Kiss | Board member of the PRIMOM Foundation, Nyíregyháza and SME advisor VOSZ | 20th September 1993 |
| I. Zsukk | Director of the Incubator of PRIMOM, Nyíregyháza | 20th September 1993 |
| I. Kovacs | Managing Director of PRIMOM, Nyíregyhaza | 21st and 28th September 1993 |

| | | |
|---|---|---|
| M. Jászai | consultant on tax issues, PRIMOM, Nyíregyháza | 21st September 1993 |
| L. Róka | marketing director, PRIMOM, Nyíregyháza | 21st September 1993 |
| I. Kelemen | Chief counsellor, SSB county Self-Government, Nyíregyháza | 22nd September 1993 |
| T. Hagymási | Chamber of Commerce North-Alföld, Nyiregyháza | 22nd September 1993 |
| F. Török | Employment centre, Nyíregyháza | 22nd September 1993 |
| B. Hajnal | Regional Director of Hungarian Central Statistical Office, Nyíregyháza | 23rd September 1993 |
| B. Kézy | Consultant, PRIMOM-Lancashire consultants, Nyíregyháza | 23rd September 1993 |
| Z. Busák | Trade manager, PRIMOM-Lancashire consultants, Nyíregyháza | 23rd September 1993 |
| A. Kovács | owner-manager of bakery, Nyíregyháza | 24th September 1993 |
| I. Vass | owner-manager of car repair shop, Nyíregyháza | 24th September 1993 |
| B. Ignácz | owner-manageress of textile company, Nyíregyháza | 25th September 1993 |
| M. Laczkovich | General Secretary, Chamber of Small and Medium-sized Enterprises, Budapest | 27th September 1993 |
| P. Süle | Advisor, Chamber of Small and Medium-Sized Enterprises, Budapest | 27th September 1993 |
| A. Soltész | Director, Foundation for Small Enterprise Economic Development, Budapest | 27th September 1993 |
| G. Faragó | Regional expert, OKFI, Budapest | 28th September and 22nd November 1993 |
| M. Laki | Institute of Economics and Centre for Private Enterprise, Budapest | 29th September 1993 |
| S. Pósvári | Project Director, Hungarian Development Foundation, Budapest | 29th September 1993 |
| P. Zoltán | Central Statistical Office, Budapest | 30th September 1993 |
| A. Kémeri | Foreign relations and marketing director, OKISZ, Budapest | 22nd November 1993 |
| A. Váradi | Director, Budapest Chamber of Commerce and Industry | 23rd November 1993 |
| I. Geza | manager, State Propert Agency, Budapest | 24th November 1993 |
| R. Young | Regional Development Advisor, Office for Phare Regional Development Programme, Budapest | 24th November 1993 |

| | | |
|---|---|---|
| M. Deszéri | Foundation for Market Economy, Budapest | 21st July 1997 |
| K. Kóka | owner-manageress hairdressing and beauty salon | 22nd July 1997 |
| J. Rogers | Centre for International Private Enterprise, USAID, Budapest | 23rd July 1997 |
| C. Iványi | Project Manager, MVA, Budapest | 23rd July 1997 |
| Z. Györfi | Public Relations Manager, Budapest Enterprise Agency | 24th July 1997 |
| I. Susuk | Foreign Relations consultant, Budapest Enterprise Agency | 24th July 1997 |
| P. Süle | Project manager, Budapest Enterprise Agency | 24th July 1997 |
| Z. Kondor | Acting Phare programme director, MVA, Budapest | 25th July 1997 |
| A. Gelei | advisor, MVA, Budapest | 25th July 1997 |
| G. Borbély | Chief Finance Officer, MVA, Budapest | 25th July 1997 |
| A. Sztánko | owner-manager of clothes retailer Budapest | 28th July 1997 |
| P. Szirmai | Budapest University of Economics and board member of VOSZ | 28th July 1997 |
| A. Rezner | Small Business Advisor, Budapest Chamber of Commerce and Industry | 29th July 1997 |
| G. Bényei | managing director, BE-TA computer company | 30th July 1997 |

Russia

| | | |
|---|---|---|
| A. Zvonkov | Consultant, 'Mosvneshinform', Moscow | 7th April 1994 |
| I. Kratko | Moscow Academy of Management, Department of Entrepreneurship, Moscow | 8th April 1994 |
| V. Popov | Moscow Academy of Management, Head of Department of Entrepreneurship, Moscow | 8th April 1994 |
| V. Zadubin | Anti-Monopoly Commission of the Russian Federation, Department for the Support of New Economic Structures, Moscow | 11th April 1994 |
| Y. Yegorov | Head of Department for the Development and Support of Entrepreneurship, Moscow City Government, Moscow | 13th April 1994 |

| | | |
|---|---|---|
| B. Yeremin | St. Petersburg University of Economics and Finance, St. Petersburg | 15th April 1994 |
| B. Nikolaev | Managing Director, private law firm 'REI', St. Petersburg | 15th April 1994 |
| Y. Malykhin | President Russian Association of Small Enterprises, St. Petersburg | 15th April 1994 |
| L. Gofman | Director, 'Agrobalt' food-processing firm, Moscow | 20th April 1994 |
| A. Chepurenko | Russian Institute for Social and Nationality Problems, Moscow | 20th November 1995 |
| R. Müller-Hahnke | consultant, EBRD programme on financial support for Russian small businesses, Moscow | 20th November 1995 |
| V. Chomsky | General Director, 'Sonata' catering firm, Moscow | 21st November 1995 |
| V. Radaev | Head of Labour Research Department, Russian Academy of Science, Moscow | 21st November 1995 |
| A. Pripisnov | Russian Institute for Social and Nationality Problems, Moscow | 22nd November 1995 |
| O. Milova | Department for the Support and Development of Small Entrepreneurship, Moscow City Government, Moscow | 22nd November 1995 |
| A. Muryanov | Russian Federation Chamber of Commerce and Industry, Moscow | 23rd November 1995 |
| V. Pimoshenko | State Committee for the Support of Small Entrepreneurship, Moscow | 23rd November 1995 |
| A. Blinov | Moscow State University, advisor to Federation Council of Russian Federation on SMEs, Moscow | 24th November 1995 |
| V. Bondarenko | Russian Association for the Development of Small Entrepreneurship, Moscow | 24th November 1995 |
| Y. Zabolotny | Prorektor, Tyumen State University, Tyumen | 29th January 1996 |
| A. Cherkashov | Tyumen State University, International High School of Business and Banking, Tyumen | 29th January 1996 |
| L. Simonova | Deputy Director, Centre for Higher Proficiency Training, Tyumen State University, Tyumen | 31st January 1996 |
| N. Vilkov | Chair of International Business Administration, Tyumen | 31st January 1996 |

| | | |
|---|---|---|
| M. Matyushenko | Director General, Tyumen Regional Support Fund of the State Support of Business Undertakings and Competition Development, Tyumen | 1st February 1996 |
| V. Vasyuk | First Deputy Director, Tyumen Regional Support Fund of the State Support of Business Undertakings and Competition Development, Tyumen | 1st February 1996 |
| B. Putilov | President, Tyumen Chamber of Commerce and Industry, Tyumen | 2nd February 1996 |
| V. Salmin | Director, 'Angar' engineering firm, Tyumen | 2nd February 1996 |
| A. Gorshkaliov | Executive Director, Small Business Development Fund of Tyumen Region, Tyumen | 5th February 1996 |
| A. Shabarov | Tyumen State University and Tyumen Scientific and Technological Park | 6th February 1996 |
| P. Krasnov | Managing Director, 'Rotunda' sawmill, Tyumen | 7th February 1996 |
| V. Shapovalov | Director, 'MITO' crafts firm, Tyumen | 8th February 1996 |
| A. Vilensky | EIM Small Business Research and Consultancy and Russian Institute for Social and Nationality Problems, Moscow | 7th June 1996 |

Appendix 2


HUNGARY
BORSOD-ABAÚJ-
ZEMPLÉN
SZABOLCS-
SZATMÁR-
BEREG
NÓGRÁD
HEVES
GYŐR-
MOSON-SOPRON
KOMÁROM-
ESZTERGOM
Budapest
HAJDÚ-
JÁSZ-NAGYKUN-
BIHAR
PEST
SZOLNOK
VAS
VESZPRÉM
FEJÉR
BÁCS-
BÉKÉS
ZALA
SOMOGY
TOLNA
KISKUN
CSONGRÁD
BARANYA
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# Appendix 3


Russia: Administrative Divisions
Republic, oblast, or kray boundary
Autonomous okrug (AOk) or autonomous oblast (AO) boundary
National capital
Oblast center
Republic
Oblast
Kray
An oblast is named only when its name differs from that of its administrative center. Moscow and St. Petersburg are federal cities having oblast-level status.
Arctic Ocean
Barents Sea
Kara Sea
Laptev Sea
East Siberian Sea
Bering Sea
North Pacific Ocean
Sea of Okhotsk
Sea of Japan
Caspian Sea
Black Sea
Aral Sea
Lake Baikal
SVALBARD (NORWAY)
FRANZ JOSEF LAND
SEVERNAYA ZEMLYA
NEW SIBERIAN ISLANDS
Wrangel Island
KURIL ISLANDS
Murmansk
Arkhangel'sk
Nenetsia (AOk)
Taymyria (AOk)
Yakutia [Sakha]
Chukotka (AOk)
Koryakia (AOk)
Kamchatka
Magadan
Petropavlovsk-Kamchatskiy
Sakhalin
Yuzhno-Sakhalinsk
Komi
Yamalia (AOk)
Evenkia (AOk)
Khanty-Mansia (AOk)
Krasnoyarsk
Khabarovsk
Amur
Primorskiy (Maritime)
Perm
Yekaterinburg
Chelyabinsk
Tyumen
Omsk
Tomsk
Novosibirsk
Kemerovo
Khakassia
Altay
Gorno-Altay
Tuva
Irkutsk
Ust'-Orda (AOk)
Buryatia
Chita
Agin (Aginskiy Buryat AOk)
Evenkiya (Yevenkiy AO)
Blagoveshchensk
Nizhniy Novgorod
Kirov
Volgograd
Saratov
Astrakhan'
Rostov
Krasnodar
Stavropol'
Tver
Yaroslavl'
Kostroma
Ivanovo
Vladimir
Vologda
Smolensk
Kaluga
Tula
Ryazan
Penza
Ul'yanovsk
Orenburg
Kurgan
Bashkortostan
Udmurtia
Mordovia
Chuvashia
Mari El
Kalmykia
Dagestan
Adygeya
Karachay-Cherkessia
Kabardino-Balkaria
North Ossetia
Ingushetia
Chechenia
Kaliningrad
St. Petersburg
Pskov
Novgorod
Leningrad
Karelia
Smolensk
Moscow
Belgorod
Voronezh
Kursk
Lipetsk
Tambov
Bryansk
Kaluga
Tula
Ryazan
Vladimir
Ivanovo
Yaroslavl'
Kostroma
Kirov
Nizhniy Novgorod
Perm
Sverdlovsk
Chelyabinsk
Bashkortostan
Udmurtia
Mordovia
Chuvashia
Mari El
Penza
Ul'yanovsk
Saratov
Volgograd
Rostov
Krasnodar
Stavropol'
Kalmykia
Astrakhan'
Dagestan
Adygeya
Karachay-Cherkessia
Kabardino-Balkaria
North Ossetia
Ingushetia
Chechenia
Orenburg
Kurgan
Tyumen
Omsk
Tomsk
Novosibirsk
Kemerovo
Khakassia
Altay
Gorno-Altay
Tuva
Irkutsk
Ust'-Orda (AOk)
Buryatia
Chita
Agin (Aginskiy Buryat AOk)
Evenkiya (Yevenkiy AO)
Blagoveshchensk
Amur
Khabarovsk
Primorskiy (Maritime)
Yuzhno-Sakhalinsk
Sakhalin
Magadan
Kamchatka
Petropavlovsk-Kamchatskiy
Koryakia (AOk)
Chukotka (AOk)
Wrangel Island
U.S.
RUSSIA
SWEDEN
FINLAND
NORWAY
DENMARK
GERMANY
POLAND
BELARUS
UKRAINE
MOLDOVA
ROMANIA
HUNG.
SLOVAK
CZ. REP.
LITH.
LAT.
EST.
Baltic Sea
KAZAKHSTAN
MONGOLIA
CHINA
NORTH KOREA
SOUTH KOREA
JAPAN
TURKEY
GEORGIA
ARMENIA
AZERBAIJAN
SYRIA
IRAQ
IRAN
AFGHANISTAN
TURKMENISTAN
UZBEKISTAN
KYRGYZSTAN
TAJIKISTAN
1 Krasnodar
2 Stavropol'
3 Adygeya
4 Karachay-Cherkessia
5 Kabardino-Balkaria
6 North Ossetia
7 Ingushetia [a]
8 Chechenia [a]
9 Mordovia
10 Chuvashia
11 Mari El
12 Udmurtia
[a] Boundary between Chechenia and Ingushetia has not been established.
[b] Chukotka may be independent of Magadan Oblast.
0
750 Kilometers
750 Miles
Base 802336 (RGC183) 8-94

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